S. Hrg. 103-217

HEARING TO EXAMINE THE ISSUE OF CREDIT AVAILABILITY FOR SMALL BUSINESS

;ARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

HEARING TO EXAMINE THE ISSUE OF CREDIT AVAILABILITY FOR SMALL BUSINESS

MARCH 4, 1993

Printed for the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE

68-234 ⇆ WASHINGTON : 1993

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-041577-2

S. HRG. 103-217

HEARING TO EXAMINE THE ISSUE OF CREDIT AVAILABILITY FOR SMALL BUSINESS

;ARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

HEARING TO EXAMINE THE ISSUE OF CREDIT AVAILABILITY FOR SMALL BUSINESS

MARCH 4, 1993

Printed for the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE

68-234 WASHINGTON : 1993

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-041577-2

C O N T E N T S

HEARING DATE

HEARING TO EXAMINE THE ISSUE OF CREDIT AVAILABILITY FOR SMALL BUSINESSES

THURSDAY, MARCH 4, 1993

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to notice, at 9:45 a.m. in room 428A, Russell Senate Office Building, Hon. Joseph I. Lieberman presiding.

OPENING STATEMENT OF HON. JOSEPH I. LIEBERMAN, A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator LIEBERMAN (presiding). The hearing will come to order. Good morning. Senator Bumpers is, of course, Chair of the Committee and has not been feeling well the last couple of days. He was going to try to come in today and I think he may be coming in. Let us put it this way: He is probably under the weather in two regards, both in terms of not feeling well and under the rain which is slowing traffic heading to the Capitol. So staff has suggested that we begin and when Dale comes in, and hopefully he will soon, obviously, I will yield the gavel to him.

We are here today to talk about a problem that continues to be of great concern to the country, to the small business community and, particularly, to areas like my own, the Northeast and Connecticut. In our region, we are simultaneously being battered by a recession and a banking crisis, which combine to form what we have now come to call the credit crunch. It is a problem that, even as the national economic indicators go up, simply refuses to go away. And the small businesses of our country suffer and the recession continues unabated in too many areas.

Connecticut today is suffering from one of the worst recessions in recent memory. Unemployment continues to rise and businesses continue to fail. The national economic indicators may be encouraging, but, unfortunately, Connecticut has entered 1993 with an economy that is still in real trouble. Since 1989, we have lost more than 200,000 jobs, which is more than 12 percent of our work force, a crushing blow for a state of our size. And what continues to be apparent is that we are not going to be able to create the new jobs to re-employ thousands of those people whose old jobs are not coming back unless the credit crunch is eased.

The Connecticut Business and Industry Association, as one indicator, completed a survey of their membership within the last month, which indicated that more than 60 percent of the respond-

ents felt that the credit crunch and credit problems still exist for them; 20 percent said the lack of credit was exacerbating the loss of jobs, and 26 percent said it was clearly slowing job growth.

Unfortunately, the danger is that the credit crunch will get worse before it gets better because, as the economy recovers and the demand for credit increases, the availability of financing for credit-worthy firms will become even more scarce, which will cause more businesses to fail and unemployment to continue rising.

The time is long overdue for the Federal government to take substantial steps to get banks back in the business of lending money. Last week, President Clinton and Chairman Greenspan took some promising first steps in that direction by announcing that they intend to ease banking regulations and bring back the bread and butter of traditional small business lending, which is the so-called character loan.

Their plan would lighten some of the collateral valuation procedures for small business loans and make it easier for bankers to appeal regulatory decisions. Those changes acknowledge that regulatory policies should not be established in isolation. Economic conditions can and should be calculated into the delicate regulatory balance that we try to maintain. A longstanding customer with an impeccable payment history simply should not be denied credit because the recession has caused a devaluation of his or her collateral. And we cannot stop there.

I have some concerns, as others do, of course, about the Basle risk-based capital standards that were fully implemented at the end of 1992 and what their effect on the credit crunch on small business lending has been. As the witnesses well know, under the new risk-based system, assets are divided into categories and risk weights are applied to each category. An asset with 100 percent weight, such as a commercial or industrial loan, requires 8 percent capital in reserve. Assets with no risks, such as government securities, are assigned a zero weight, meaning that no capital reserve is required. Government securities therefore, become more attractive.

In a capital-crunched region such as New England, these capital requirements—particularly when taken in combination with the inherently greater risk of small business lending, the regulatory burden I have discussed, and the current rates of return—have led banks to invest heavily in U.S. Government obligations. There has been a significant shift in assets from the job-producing commercial and industrial loans to government securities. I worry that our government itself has created an incentive for banks to divest from commercial and industrial loans into government securities, which is one of the key factors in the credit crunch.

I also think we have to take a look at the regulatory burden facing banks, as we will hear from representatives of the banking industry this morning, and I think we have to do it with an eye toward the cumulative regulatory burden, not just individual parts. There is no doubt that the aggregate regulatory burden is too heavy, but where we begin to trim that burden is a question, a delicate question, and one I think we have to consider thoughtfully.

Finally, there have been some very innovative suggestions made lately about how to deal with the small business lending crisis that require very, very early consideration by Congress. The securitiza-

tion of commercial and industrial loans is one interesting idea. The development of community development banks is another. A secondary market would add liquidity to the banking system and make small business lending more attractive, and we ought to work together with the administration to try to implement those proposals.

The credit crunch, as I have indicated, is strangling the economy of New England and other sections of the country.

Without action, banks cannot provide credit; without credit, businesses cannot grow; and without business growth, jobs cannot be created.

We have a very strong group of witnesses here this morning. I look forward to hearing them, and I hope that their testimony will enable this Committee to take the lead in this Congress, working within the Congress and with the administration, to end the credit crunch that is impeding the economy recovery.

Senator Burns?

STATEMENT OF HON. CONRAD BURNS, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator Burns. Thank you, Mr. Chairman. I will keep my remarks very brief.

I think this Committee is very fortunate in having you on this Committee and, especially, on this particular subject because of your experiences as an attorney general at the state level and when we start talking about some of the things that are really hampering our banks today in doing business.

Very simply, 98 percent of businesses in Montana are small businesses. They supply 76 percent of the job market in Montana. So, very simply put, we have some real concerns about what is going on in my state.

It seems as though here in Washington we start talking about our different regions and how they differ—Montana is nothing like Connecticut—but yet, when we try to start dealing with legislation and especially the enactment of laws to address a particular situation, we have a problem in trying to write a law so that one size fits all.

That is not the case in this great and diverse country. We try to do it in our agricultural policy, we try to do it in our environmental policy, one size fits all. And then you pass the law and turn it over to the agency to write the rules of the law how they interpret the intent of Congress. And Congress has been very lax or, I would say, remiss in not getting involved in the rulemaking part of the law after it has been passed.

Nonetheless, we went through our hard times in the mid-80s in the Midwest and, of course, the West. Both coasts were booming but our land prices plummeted, our tax base disappeared. We had foreclosures on good businesses and then allowed bad businesses to go ahead and operate. Most of that was because our equity went down, and even though we were making payments on loans, good loans were foreclosed on for some reason or other and we found that hard to deal with.

The common problem that seems to run through this thing is rules and mandates and regulations. And I think that is what we kind of want to focus on as these hearings go on.

I want to thank the Chairman, Senator Bumpers, for these hearings because I hope we will identify the problem. Whether we can deal with it or not from a legislative standpoint remains to be seen.

I just want to bring up, for example, in our state, the Community Reinvestment Act is a problem. Why does a small bank in Terry, MT. have to do the paperwork for CRA? Where else are they going to loan the money? Along with the Community Reinvestment Act, you have something that my bankers are talking to me about and that is the Criminal Reporting Act that is causing some concern up and down the lines when it comes to banking. That is my independent bankers in Montana who are telling us that.

In a state like Montana, CRA or Community Reinvestment does not mean that much. We are 148,000 square miles, we are agriculture, and we have only got 800,000 people. Where else are we going to go to invest our money?

Strong banks are actually the foundation on which we build our economies.

In Montana, we have had four very good years. In fact, our net income for our citizens has led the Nation in the last 4 years because we have got natural resources. Sure, we go through our peaks and our valleys; but, nonetheless, I can also really be concerned about some of our states that are not resource-based, that do not have a renewable resource for an underpinning of their economy.

We have to find a way to address not only the problems in Connecticut but, also, make sure that our situation is taken care of in the West, and particularly in Montana, because we cannot fashion a law that one size sort of fits all. And I thank you, Mr. Chairman.

[The prepared statement of Senator Burns follows:]

Prepared Statement of Hon. Conrad Burns

Mr. Chairman, I would like to thank you for holding this hearing today.

In my home State of Montana, 98 percent of our businesses are considered small businesses. They supply 76 percent of the jobs in our state.

Very simply I will state to you and the members of this Committee the concerns I have heard from the bankers in Montana.

Unlike the Northeast, our banks have money to lend. Our economy is not booming but at the same time it is climbing out of what has been a long slow period. Montana bankers are still cautious but they look at the next 10 years fairly positively.

However, one common problem continues to burden both the banks and the small business owners. REGULATIONS. Costly regulations. Business men and women are very cautious about expanding or opening their businesses. They are not confident that by the time they pay the federal government, the State government, the cost of fulfilling the legal regulations, the accountants, the lawyers, the insurance company and the piper that there will be anything left over OR more critically, that there will be enough to cover the cost of doing business.

Banks tell me they have the money to lend to our existing and potential business owners. BUT, they also have the unreasonable burden of MANDATES that cost them and the borrower. This clouds the lending process in such a way that they feel the crunch of just doing business.

For example, the CRA, Criminal Reporting Act. If a depositor changes their typical pattern of doing business a red flag goes up and a investigative request is sent to the FBI. That process has to be paid for by somebody.

Mr. Chairman, it is important to determine all of the factors that have created this problems banks and borrowers face today. While it is true the various regions of this country are facing different economic levels I believe that they all are sharing the same frustration in delivering the product of investment money to the builders of our communities. Without the flow of capitol into the cities and rural areas commerce would cease to exist.

I want to work with you and our colleagues on this Committee to bring the hammer down on putting more burden to our businesses and work actively to lessen the existing burden they carry today.

Thank you Mr. Chairman.

Senator LIEBERMAN. Thank you, Senator Burns.

Senator Wellstone?

STATEMENT OF HON. PAUL DAVID WELLSTONE, A U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator WELLSTONE. Thank you, Mr. Chairman. Let me be very brief. When we held hearings on this problem of the small business credit crunch in October 1991, we were dealing with the question of whether the crunch was a result of prudent policy, combined with just economic downturn, worsening economic conditions, or whether it was the result of the pendulum swinging too far in the direction of over-regulation in response to some of the abuses that had taken place in lending practices in our country.

In the State of Minnesota I think it is fair to say that among bankers and economists and business people there is still a division of opinion as to the why of it all. And certainly, Mr. Chairman, we have not experienced in Minnesota the same kind of crunch—I expressed that in October—as you have, for example, in Connecticut. Nevertheless, we have seen a dramatic expansion of demand for the 7(a) guaranteed loan program.

And I do believe that the whole question of whether or not bank regulation needs to be redirected to allow good risk lending to small and medium-sized businesses, which is very much at the front end of our agenda here in the Committee as it is with the administration, is one that I have a strong interest in.

I would just like, by way of conclusion, to make a special plea for a focus on the credit problems facing small businesses in rural America. I really feel honored to be able to chair a Committee, and we are going to get going next week, on the rural economy—the Subcommittee on Rural Economy and Family Farms. And in that spirit, rather than detailing problems, Mr. Chairman, I would like to submit for the record a brief statement by Kristen Juliar of Region IX Development Commission in Mankato—that is southwest rural Minnesota—where she outlines a whole set of what she considers to be credit problems in relation to small businesses and lending institutions in rural Minnesota, which I think applies to rural America as well.

I thank you for being here today, Mr. Mullins.

[The prepared statement of Senator Wellstone follows with the letter referred to attached thereto.]

PREPARED STATEMENT OF HON. PAUL DAVID WELLSTONE

Mr. Chairman, I appreciate that we are holding this hearing on a topic which is important to many small business people in my state.

When we held a hearing on the same topic here in October 1991, we hoped that we could answer the question: does the small business credit crunch represent prudent caution or an unintended stifling of economic activity by federal regulators?

That is, is the credit contraction facing many small businesses mainly a result of economic conditions, or, on the other hand, is our regulatory response to abuses by some financial institutions in the 1980s now burdening other types of financial institutions and hence denying credit to creditworthy potential borrowers, especially small and medium-sized business borrowers?

In my state, at least, the question seems to remain one whose answer neither economists nor bankers agree on.

The situation has never been as dire in Minnesota as in some states. As I pointed out here in 1991, total lending in my state has been fairly stable in recent years. One result, however, of the occasional difficulty some small business people have had in obtaining commercial credit is that, in Minnesota, as across the country, demand for the SBAs 7(a) guaranteed loans has been up dramatically.

I think the question of whether bank regulation needs to be redirected to allow more good-risk lending to small- and medium-sized lending is important. And I am supportive of the intentions of President Clinton, Fed Chair Greenspan and those on this Committee who are looking closely at this question.

But I think I will use this opportunity to make a special plea for a focus on the credit problems facing small businesses in rural America. As the new Chair of this Committee's Subcommittee on Rural Economy and Family Farms, I hope to begin working soon with you, Mr. Chairman, who I know share my concern for these special problems, and with my other colleagues on that Subcomittee, to address that topic.

With that in mind, I would like to submit for the record a very brief statement from Hristin Juliar of the Region 9 Development Commission in Mankato, Minnesota, which serves the Southwestern part of my state. Ms. Juliar's testimony outlines some of the specific problems facing rural lenders and rural small business people.

Mr. Chairman, I also will be pursuing the matter of how we can make sure that rural areas are served by SBA programs such as the 7(a) loan guarantee program.

SENT BY: ; 3- 3-93 ;11:53AM ;REGION NINE DEV. COM→ 12022248438;# 2

Region Nine
DEVELOPMENT COMMISSION
P.O. Box 3367, Mankato, Minnesota 56002
(507) 387-5643 (800) 450-5643 FAX (507) 387-7105

DATE: March 3, 1993

TO: Brian Ahlberg

FROM: Kristin Juliar, Deputy Director Kris

RE: CREDIT AVAILABILITY FOR SMALL BUSINESSES

The Region Nine Development Commission operates a Small Business Administration Certified Development Corporation and packages SBA 7A loans in nine rural counties of south central Minnesota.

Access to credit for small businesses in rural areas is a problem for several reasons. Banks in small communities have a limited volume of business loans, and thus a lack of experience in analyzing risk and credit worthiness. Small town banks have expertise in agricultural loans, and experience with existing businesses, but do not have experience in credit analysis of start-up businesses. This limits availability of credit to new businesses.

As a result, small town banks typically require highly collateralized loans, with very high equity. Additionally, regulations regarding how lenders establish the value of collateral have made it more difficult for small businesses to acquire credit.

A third issue is that small banks have lending limits that are far below the needs of businesses in their communities.

The loan guarantee programs of SBA are ideally suited to addressing these issues. SBA performs a credit analysis, and has extensive experience in small business. The loan guarantee will reduce the risk to the lender, and the result is more reasonable equity and collateral requirements. The guarantee allows the bank to participate in loans beyond the lending limit. SBA really works in rural areas.

A challenge to the success of SBA is the increasing workload on existing loan officers. The volume of loans has been increasing, but the number of loan officers has remained the same, or perhaps decreased. If the result is increased processing time, businesses and lenders will become discouraged, and the program would not be used as it should.

In summary, there are problems related to credit availability in rural areas that inhibit business start up and expansion. SBA provides an important tool for making credit more available.

Senator LIEBERMAN. Thank you, Senator Wellstone.

Senator Pressler, I apologize for not calling on you first as ranking member. I was blinded by Senator Burns' beauty.

[Laughter.]

STATEMENT OF HON. LARRY PRESSLER, A U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator PRESSLER. Mr. Chairman, I think many good things have been said here by my colleagues and I will not add very much to them except to say that credit in our economy because of the way it is structured, is extremely critical. In my state, as in Senator Burns' state, we have not gone through some of the banking problems that maybe you went through in Connecticut or in other states the last few years.

I think—this is my personal view—our bankers were very conservative in terms of some of the loans they would make. We did not have the kind of S&L problem that Texas had, for example. On the other hand, we do not have the kind of economic growth, I suppose, that some of that risk-taking encourages.

However, I will be very intrigued to hear our witness from the Federal Reserve because I am fascinated by what has been occurring in our economy. Some say that when the bond market is high, it means we are going to have a recession for a period of years. That is what I have always thought. But now I read in the papers that when the bond market is high it means people are optimistic that we are not going to have a recession. So different people apparently read that in different ways.

There are a number of things in this Small Business Committee that we are concerned about, but I think credit would have to be at the heart of them, because most small businessmen and women do not want Federal handouts but they do want money to operate. We had a good hearing here the other day on microloans in which we talked a good deal about credit availability. I also had a meeting with South Dakota loggers in Spearfish, SD, and the biggest thing they are looking for is a supply of good, reliable credit.

There are a number of related issues. In order to ease the regulatory burden on banks I recently cosponsored S. 265, the Economic Growth and Regulatory Paperwork Reduction Act of 1993, which is something of great interest to small businesses. Perhaps after credit, that is the largest issue.

The issue of helping small businesses get started and continue is something I believe we need to do principally through the private sector. I am one who is very hesitant about government involvement, although I have supported the 7(a) loan program and the microloan program. But I look forward to learning this morning from a leading member of the Board of Governors of the Federal Reserve, and I welcome you here.

Thank you, Mr. Chairman.

[The prepared statement of Senator Pressler follows:]

PREPARED STATEMENT OF HON. LARRY PRESSLER

Thank you Mr. Chairman. I am pleased we are holding this morning's hearing on the credit crunch and its effects on small businesses. It is a critically important issue.

Access to credit is vitally important to small businesses across the country. Almost 40 percent of small businesses classify themselves as regular borrowers. Nearly 45 percent obtained at least some of their start-up capital from banks.

While my home State of South Dakota has not had a serious "credit crunch," the lack of available credit in other states is a real problem which has hurt our Nation as a whole. Bank lending is down 10 percent in the last 2 years. We must find ways to get more credit out to the small business entrepreneurs who can turn that money into new jobs.

Government overregulation has contributed to credit difficulties for banks and small businesses. A recent independent study conducted by economists with the Federal Reserve Bank of Boston showed a direct link between regulatory enforcement actions and the decrease in bank loans to bank-dependent sectors of the economy. This connection has long been suspected. Indeed, bankers in South Dakota have repeatedly told me of their frustrations over trying to make loans in the regulatory atmosphere of the last half decade. Now we have empirical evidence to prove the point.

In addition to overregulation, the decline of real estate values in recent years has diluted the main source of collateral for many small business owners. When bankers are forced to look only at the numbers and ignore a business' "character" or loan repayment history, what was once a good loan can become troubled, and a profitable business can get left out in the cold.

In order to help ease the regulatory burden on banks, I recently cosponsored S. 265, the "Economic Growth and Regulatory Paperwork Reduction Act of 1993." This bill would reduce the number of unnecessary regulations while maintaining the health and stability of the banking system. This can be achieved by cutting back regulatory micromanagement and reducing the amount of paperwork that must be completed by banks and consumers. While, as I mentioned, the credit crunch has not been as severe in States like South Dakota, bankers from my home state have shared many paperwork horror stories with me. While banks have money to lend, the paperwork burden sometimes makes certain loans impractical. Quite simply, that means federal regulations and forms have reduced the amount of credit available to our small businesses.

I look forward to hearing the testimony of our witnesses this morning and welcome them to the Committee. I believe this hearing will help determine which direction Congress should take in attempting to relieve the credit crunch and help banks make more loans to small businesses.

Senator LIEBERMAN. Thank you, Senator Pressler.

Senator Wofford?

STATEMENT OF HON. HARRIS WOFFORD, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator WOFFORD. Mr. Chairman, I should not take long either because I just left a group of Pennsylvania bankers who were envious of me hearing Governor Mullins. And then I went to a group of community-based organizations, who excused me from their big affair to be here. The credit crunch facing small business in the communities where they are trying to fight poverty is something they feel very strongly about in Pennsylvania and elsewhere. To them I said I was eager to hear our two Pennsylvania banker colleagues, James Lauffer from Irwin and William Rossman from Altoona.

So let me just say that we feel this credit crunch, the lack of credit for small businesses, seriously in Pennsylvania. I am very glad that the administration and the Federal Reserve Chairman have agreed to review their regulations of financial institutions. I think everybody agrees that our economy cannot afford unnecessary regulation. I heard about the 60 to 80 forms that have to be signed for a loan nowadays. The Mayor of Philadelphia told how he thought he could get through his ceremony in 10 minutes and he

was there 55 minutes before he had finished signing all the forms in one such venture.

I heard last night the President and the Vice President outline their crusade against bureaucracy and red tape, and I hope it applies to the subject we are talking about because regulations should not be implemented in a manner that is overly burdensome to people in this country and, particularly, to small businesses, which are the source of most of our new jobs and getting out of this recession.

If legislation is warranted after the review, then we should get to work on it, and I think we need to actively consider proposals put forth by my colleagues. And I particularly salute you, Mr. Chairman, Senator Lieberman, for your leadership on this issue. And I also hope that we do not forget the unmet credit needs of minority-owned businesses and firms actively involved in exporting.

Thank you, Mr. Chairman.

Senator LIEBERMAN. Thank you, Senator Wofford.

Senator Coverdell?

Senator COVERDELL. Mr. Chairman, I yield in deference to the testimony.

Senator LIEBERMAN. Thank you, Senator.

Senator Bennett?

Senator BENNETT. I follow.

Senator LIEBERMAN. OK. Thank you both very much.

The first witness is the Honorable David Mullins. I will indicate to you again that Senator Bumpers wanted very much to be here. When he spoke to me yesterday, telling me that he was concerned that his flu might keep him from being here, he mentioned that he was particularly anxious to be here because Bill Brandon of the First National Bank of Phillips County in Helena, AR was going to be testifying for the ABA. And I teased him that, once again, he had put an Arkansas flavor to the hearing.

Then he told me that the Honorable David Mullins had grown up or spent a part of his childhood in Arkansas and his Dad had been the President of the University of Arkansas. And I teased him a little more, and he said that these two gentlemen just prove that people from Arkansas tend naturally to rise to the top.

[Laughter.]

And with that, Mr. Mullins, Vice Chair of the Board of Governors of the Federal Reserve, we welcome you and look forward to your testimony.

STATEMENT OF HON. DAVID W. MULLINS, JR., VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. MULLINS. Thank you, Mr. Chairman. It has been a good year for Arkansas, I guess.

Mr. Chairman, Members of the Committee, I am pleased to be here this morning to discuss the credit crunch and the availability of credit for small businesses. The financing of small business enterprises is a central issue in the future growth and vitality of the U.S. economy. Small businesses account for almost two-thirds of the Nation's work force and created 80 percent of the new jobs in the 1980s. It is because of the importance to the growth of the U.S.

economy, especially job growth, that the issue of credit availability for small business is an important public policy concern, one worthy of rigorous analysis and concrete action.

Why have business loans fallen? In our view, there are a number of contributing factors. First, the demand for bank loans typically declines during recessions as economic activity slows. In the recent downturn, this has been amplified by a broad-based desire by businesses to reduce their dependence on debt, following a decade in which debt financing expanded to historically very high levels.

Moreover, in the aggregate numbers on business debt, a significant volume of funds raised in the public capital markets by large businesses has been used to pay down bank loans.

A second factor is the condition of the U.S. banking industry. Debt financing of the 1980s left banks with record non-performing loans and produced large loan losses, which reduced the capital base of the U.S. banking industry. In response, the banking industry over the past two and a half years has focused primarily on identifying and working out bad loans, building capital and liquidity. While this retrenchment process may have adversely affected loan growth in the short term, it was a necessary prerequisite to the industry's return to the financial strength necessary of supporting and sustaining new lending and growth.

It should be noted that, in our view, the Basle risk-based capital standards appear not to have played a disproportionate role in motivating banks to increase capital during this period. For example, virtually all types of financial institutions, including credit unions and finance companies not subject to Basle, responded in a very similar manner to this economic environment of de-leveraging and impaired asset quality. Banks faced with large losses felt pressure to increase bank capital far beyond the Basle regulatory minimum. Banks themselves wanted the comfort of a larger capital buffer; capital markets demanded higher capital for low-cost access to funds; and regulators and changes in regulatory statutes reinforced these pressures.

A third factor is the legislative and regulatory response to the large volume of failures of insured financial institutions in the late 1980s, both S&Ls and banks. The passage of the S&L reform legislation, FIRREA, in 1989 and the FDIC Improvement Act, FDICIA, in 1991 produced a substantial increase in regulatory burden on the industry. While many of these new regulatory requirements have been worthwhile and important and have enhanced safety and soundness, a not insignificant portion of these new requirements seem cumbersome and of questionable utility, imposing costs on the industry without commensurate benefits to safety and soundness. The increased burden has raised the cost of financial intermediation and adversely affected both the cost and availability of bank credit.

Moreover, these statutes change the fundamental nature of bank supervision and regulation. The process dictated by FIRREA and FDICIA became more standardized, more mechanical, and more dependent upon documentation, analytical formulas, and rigid rules as opposed to examiner judgment. This may have had an unintended disproportionate adverse impact on small business loans, which are often character loans—cash flow loans requiring judgment—

where the bank's return comes from a thorough knowledge and close working relationship with the borrower. These loans are heterogeneous in nature. Each one is different, and they may be less amenable to the increasingly standardized nature of supervision and regulation. These new regulations likely raise the fixed costs associated with small loans, which require much the same documentation as large loans.

In contrast, the recent changes in regulations may have implicitly encouraged lenders to focus more on homogeneous standardized lending products, such as mortgages and consumer loans, which are more easily documented, scored and categorized. It is true that a more rigorous supervisory process has many beneficial consequences, but one unintended effect may have been to make small business lending more difficult and costly because such a regulatory process may be, in many ways, simply inconsistent with the inherent nature of small business lending.

Where do we stand today? U.S. banking industry has made impressive progress in improving its financial health. Over the past 5 years, U.S. banks have charged off $125 billion in bad loans, yet have increased reserves and added more than $80 billion in equity capital. Moreover, 1992 was a record year for bank profitability, and bank capital ratios now stand at the highest level in more than a quarter of a century.

While this retrenchment process has been painful and may have affected credit availability during the adjustment period, the banking industry now appears to have a strong capital base and ample liquidity necessary to fuel the economic recovery. The recently revised estimate of 4.8 percent GDP growth in the fourth quarter of 1992 confirms that

U.S. economic growth accelerated markedly during the second half of last year. This suggests that loan demand should be picking up as well; thus, both improved supply and demand cyclical factors bode well for the outlook for increased business lending.

What can be done to increase the availability of credit for small businesses? As cyclical conditions improve, we need to ensure that regulatory processes do not impede the flow of credit to small business. Suggestions for accomplishing this include exploring ways to reduce excessive documentation, perhaps by considering small business loans as a portfolio rather than requiring each individual loan to bear the full regulatory documentation burden, an approach currently employed for consumer loans.

Some have also suggested examining whether the FIRREA real estate appraisal requirements have unintentionally imposed an undue burden on business loans which often involve real estate collateral. More generally, it is useful to explore ways in which the regulatory process might be tailored to be more congruent with the inherent nature of business lending, rather than trying to force business lending into a standardized regulatory mode.

To this end, the Treasury Department, the Federal Reserve, and the other banking agencies are engaged in a systematic analysis of the possible regulatory impediments to business lending. The objective is to design a set of regulatory actions which will eliminate unwarranted impediments to lending. The scope of the analysis encompasses the full range of issues associated with regulatory

burden on banks, possible problems in the examination process, as well as an explicit focus on impediments to small business lending.

In attempting to streamline the regulatory procedures for small business lending we are all committed to maintaining essential standards of safety and soundness, including adequate capital standards. While it is premature to discuss specifics, a detailed set of proposals should be completed in the near future.

In addition, there are other measures such as securitization, as the Chairman and others have mentioned, that need to be explored more generally. I would mention the Board of Governors initiated a major research project late last year on the issue of small business finance which underscores our commitment to understanding this important component of the economy.

In summary, Mr. Chairman, the outlook for small business finance seems encouraging. Loan demand should be reviving as the economic recovery progresses, and the U.S. banking industry now possesses a strong capital base and ample liquidity to support increased lending. Nonetheless, the down trend in bank business lending and the importance of small businesses to job growth suggest that it would be unwise to remain complacent and rely entirely upon improving cyclical conditions to fuel small business loan growth. This is why we are working actively to try to identify and eliminate any unwarranted bank regulatory impediments to lending. We feel this effort is wholly consistent with the Federal Reserve's fundamental objective of promoting maximum sustainable, non-inflationary growth in the U.S. economy.

Thank you, Mr. Chairman. I would be happy to respond to questions.

[The prepared statement of Mr. Mullins follows:]

PREPARED STATEMENT OF HON. DAVID W. MULLINS

Mr. Chairman and Members of the Committee. I am pleased to be here this morning to discuss the credit crunch and the availability of credit for small businesses.

The financing of small business enterprises is a central issue in the future growth and vitality of the U.S. economy. Small businesses account for almost two-thirds of the nation's workforce. They created 80 percent of the new jobs in the 1980s, a decade in which the U.S. economy created almost 20 million jobs, despite the fact that Fortune 500 firms reduced their employment.

The sources of small business financing are substantially more limited than those of large firms with continuous access to the depth and liquidity of public capital markets. For debt financing, small businesses are generally dependent on financial institutions, primarily commercial banking firms. It is because of the importance of small businesses to the growth of the U.S. economy, especially job growth, that the protracted weakness in business loans at banks is an important public policy concern—one worthy of rigorous analysis and concrete action.

Why have business loans by banks fallen? In our view, there are a number of contributing factors on both the demand side and the supply side of this market.

First, the demand for bank loans typically declines during recessions as economic activity slows, reducing firms' needs for working capital and new plant and equipment. In the recent downturn this has been amplified by a broad-based desire by businesses to reduce their dependence on debt financing. This leveraging phenomenon, which has been apparent for both businesses and households, followed a decade in which debt financing expanded to historically very high levels. Excess leverage in conjunction with a weak economy reduced the credit worthiness of many firms as well.

Federal Reserve surveys indicate that supply side constraints on the availability of financing may have played a role in reduced business borrowing. They demonstrate that large banks have systematically tightened the terms and standards for granting business loans to customers of all sizes. Of course, some of this tightening

was likely justified as an appropriate response to the lax credit standards of the 1980s and the resulting heavy loan losses of the early 1990s. Although no substantial reversal or easing is yet apparent, our surveys indicate that tightening of credit standards has ceased.

An important factor influencing the availability of financing during this period has been the condition of the U.S. banking industry. The debt financing of the 1980s left banks with record nonperforming loans—especially commercial real estate loans—in the early 1990s. These asset quality problems produced large loan losses which reduced the capital base of the U.S. banking industry. In response, the banking industry over the last 2½ years has focused on identifying and working out bad loans, and rebuilding capital and liquidity. In short, the banking industry has been engaged in an intensive process of financial healing—dealing with embedded asset quality problems and rebuilding its financial strength.

This retrenchment process has involved reducing loan growth, investing in government securities, cutting expenses to enhance earnings, retaining a larger portion of these earnings, and issuing new equity to bolster depleted capital bases. While this process may have adversely affected loan growth in the short term, it was a necessary prerequisite to the industry's return to financial strength capable of supporting and sustaining new lending and growth.

It should be noted that, in our view, the Basle risk-based regulatory capital standards appear not to have played a significant role in motivating banks to curtail lending. During this entire retrenchment period, the overwhelming majority of U.S. banks met these minimum standards, most by a very wide margin. Indeed, those banks with capital far above the minimum standards have been responsible for the overwhelming majority of bank investment in government securities. In investing in government securities, it is not likely that these very well capitalized banks were motivated by minimum capital standards. Finally, other financial institutions not subject to Basle risk-based standards, such as credit unions and finance companies, exhibited the same pattern of retrenchment characterized by reduced lending growth and increased investment in government securities. This suggests that neither Basle capital standards nor bank examiners were primarily responsible for these adjustments. Indeed, all financial institutions responded in a similar manner to this economic environment of deleveraging and impaired asset quality regardless of whether they were subject to risk-based capital standards.

The pressure to increase capital beyond the regulatory minimum—in effect to build a notable cushion of capital above the minimums—came from several sources. Faced with uncertain large loan losses, banks themselves raised their assessment of the necessary capital base to sustain future lending; the capital markets demanded higher capital in order for banks to have low-cost access to funds; regulators, and changes in statutes, recognized that a sound capital base is the best protection for the federal safety net and the taxpayer. All concluded that adequate capital is required for banks to be able in the future to sustain lending in both good times and bad.

Finally, it is worth noting that this is a worldwide phenomenon. The retrenchment from the financial imbalance built up in the 1980s has produced stress in financial institutions in Japan, the U.K., Sweden, and Australia to name a few countries. This financial retrenchment has contributed to the economic slowdown in many industrial countries. Both in the United States and the rest of the world, it is quite likely that some banks, some bank lending officers, and some bank examiners may have become overly cautious. Indeed, in the United States, the federal banking agencies, and the previous and current administrations, have attempted to assure that our examiner staffs and examination guidelines do not impede the flow of sound loans to credit-worthy borrowers. These efforts continue.

Where do we stand today? The U.S. banking industry has made impressive progress in improving its financial health. Over the past 4¾ years through the third quarter of 1992, U.S. banks have charged off $123 billion in bad loans; yet increased reserves by $5 billion and added $77 billion in equity capital. Moreover, with loan loss allocations declining and after several years of stringent cost controls, 1992 was a record year for bank profitability. Bank capital ratios now are the highest level in more than a quarter of a century. While a segment of the industry remains under stress, the bulk of the U.S. banking industry has made remarkable progress in working through a very difficult economic cycle and emerging with renewed financial strength.

While this retrenchment process has been painful and may have constrained credit availability during the adjustment period, the banking industry now appears to have a strong capital base and ample liquidity to fuel the economic recovery. In addition, the interest rate spreads on small business lending appear attractive rela-

tive to alternative bank investments, and the deleveraging process by firms seems to be well advanced, though perhaps not entirely completed.

The recently revised estimate of 4.8 percent GDP growth in the fourth quarter of 1992 confirms that U.S. economic growth accelerated markedly during the second half of last year. This suggests that loan demand should be picking up as well. Thus, both improved supply and demand cyclical factors bode well for the outlook for increased small business lending.

There are signs that business lending at smaller banks-whose customers tend to be smaller firms—may have begun to strengthen. Such increases in small business loans may well be masked in the aggregate data by the extensive restructuring of corporate debt. In recent years, larger businesses with access to the public capital markets have issued record volumes of bonds and stocks and used much of the proceeds to repay short-term debt, including bank loans. More generally, for at least two decades, banks have found it difficult to retain those large business customers who can directly tap U.S. and foreign markets more cheaply. This widely recognized trend has contributed to a decline in business loans as a share of total bank assets. While this trend may well continue, small businesses will remain reliant on banks for their external finance. Thus, the continued importance of banks to small businesses warrants taking a look at those factors that may be constraining credit to small firms that do not have access to public capital markets.

One possible contributing factor may be changes in the nature of bank supervision and regulation in recent years. The 1980s were characterized by a sharp increase in the failure of federally insured financial institutions, both S&Ls and banks. In response, rigorous regulatory statutes were enacted including the S&L reform legislation, FIRREA in 1989, and the FDIC Improvement Act, FDICIA, in 1991.

These statutes produced, directly and indirectly, a substantial increase in regulatory burden on the banking industry. For example, each of the federal banking agencies had to create over 60 separate working groups to write the regulations to implement FDICIA regulations, a process which is still not entirely completed. This process itself likely contributed to subdued loan growth. Banks may have been understandably hesitant to launch major new lending initiatives before knowing the standards and regulations that would apply to these new loans.

While many of these new regulatory requirements have been worthwhile and important and have enhanced safety and soundness, a good many provide less clear-cut benefits that may not justify their cost in terms of increased burden. Higher burdens raise the cost of financial intermediation and can adversely affect the cost and availability of bank credit. Recent research by Fed staff has suggested that the least risky and lowest cost credit extensions to smaller businesses by banks in the 1980s were unsecured relationship lending. If recent statutory and regulatory changes have required additional documentation or collateral on such loans, the quantity of lending to these safer borrowers may have declined, because banks pass through the additional underlying costs or because these borrowers cannot provide the additional documentation or collateral.

Indeed there is every reason to think that recent regulations and statutes have changed the nature of supervision and regulation. The process has become progressively more standardized and mechanical, more dependent on documentation, analytical formulas, and rigid rules as opposed to examiner judgment. This may have disproportionately affected small business lending, which often takes the form of character and cash-flow loans, requiring judgment, and where the bank's return comes from a thorough knowledge and working relationship with the borrower. These loans are heterogeneous in nature, and they may be less amenable to the increasing standardized character of supervision and regulation.

At the same time, the focus on homogeneous, standardized lending products may have encouraged lenders to shift toward areas such as mortgages and consumer loans, which are more easily documented, scored and categorized. To understand the potential bias from this process, one need only to consider the cost and difficulty in documenting—especially for public or examiner scrutiny—the soundness of a character loan for small firms with unaudited financial statements. Compare this to placing funds in standardized mortgages, in mortgage-backed securities, or consumer loans amenable to computerized credit scoring.

Now it is true that a more rigorous supervisory process has many beneficial consequences. But one unintended effect may have been to make small business lending more difficult and costly ¶ 9because such a regulatory process may be in many ways simply inconsistent with the inherent nature of small business lending.

What can be done to ensure the availability of credit for small businesses? First, we need more rigorous insight into the nature of small business finance, and, to this

end, the Federal Reserve Board last year initiated a substantial research project to sample the financial behavior of a large number of small business firms. This study will focus on the full range of financing alternatives available to small business, not just bank financing. The objective is to gain a rigorous understanding of the nature, problems and trends in this area. This is a major research project which will take some time to complete, and it underscores the Board of Governors' commitment to this important component of the economy.

As for the near term, we need to ensure that the regulatory process does not impede the flow of credit to small businesses. The suggestions for accomplishing this that have appeared in the public debate include exploring ways to reduce excessive documentation, perhaps by considering small business loans as a portfolio, rather than requiring each individual loan to bear the full regulatory documentation burden—an approach currently employed for consumer loans. Some have also suggested examining whether the FIRRBA real estate appraisal requirements have unintentionally imposed an undue burden on business lending, a large portion of which involves real estate collateral. More generally, it is useful to explore ways in which the regulatory process might be tailored to be more congruent with the inherent nature of small business lending, rather than trying to force business lending into a standardized regulatory mold.

To this end, the Treasury Department, the Federal Reserve and the other banking agencies are engaged in a systematic analysis of the possible regulatory impediments to business lending. The objective is to design a set of regulatory actions which will eliminate unwarranted restraints on lending. The scope of the analysis encompasses the full range of issues associated with the regulatory burden on banks and possible problems in the examination process. In addition, we believe it is important to focus explicitly on impediments to small business lending. In attempting to streamline regulatory procedures for such loans, we are all committed to maintaining essential standards of safety and soundness including adequate capital standards. While it is premature to discuss specifics, a detailed set of proposals should be completed in the near future.

A further avenue of attack for this problem, and one that has been proposed in various forms is securitization. Securitization of business loans could measurably increase access to capital for small businesses. Such programs would be most productive for loans other than relationship loans, since the latter are not easily standardized. Because of the heterogeneous nature of small business loans, this will not be easy. More work needs to be done to standardize loan terms and various legal, regulatory and accounting problems need to be resolved before securitization will be feasible.

We at the Board of Governors generally favor efforts, including appropriate legislation, that would encourage securitization. We generally do not favor the establishment of a new government-sponsored enterprise involving business loan securitization because of our concern about adding to the already enormous overhang of contingent government liabilities.

While securitization has the potential to increase credit availability for small businesses, there will still likely remain an important role for banks in small business financing. Securitization is unlikely to be feasible for a basic staple of small business lending—the character loan. These loans are critically dependent on lenders' judgment, their knowledge of the firm, its principals, business and community, and they require an ongoing working relationship between the lender and the borrower. Even if securitization is successful, there are a large number of borrowers whose loans will not lend themselves to securitization. These borrowers are likely to remain dependent on a healthy flow of bank credit.

In summary Mr. Chairman, the outlook for small business finance seems encouraging. Loan demand should be reviving as the economic recovery progresses, and the U.S. banking industry now possesses a strong capital base and ample liquidity to support increased lending. Nonetheless, the weakness in bank business lending and the importance of small businesses to job growth suggest that it would be unwise to remain complacent and rely entirely on improving cyclical conditions to fuel small business loan growth. This is why we are working actively to try to identify and eliminate any unwarranted bank regulatory impediments to business lending. We feel this effort is wholly consistent with the Federal Reserve's fundamental objective of promoting maximum sustainable noninflationary growth in the U.S. economy.
Thank you Mr. Chairman.

Mr. LIEBERMAN. Thank you, Mr. Mullins. With the Chairman who just arrived, I am going to impose on myself, and ask that we

do so for the other members, a 5-minute rule for questioning so we can move around.

I thank you very much for your statement, for the recognition that you have given to the critical role that small business has to play in our recovery because of the fact that it creates two-thirds of the jobs, and the fact that there still is a credit problem that we have to do something about.

I want to refer you to the chart up there, which is a little bit hard to see, but it is a chart that gauges the net change in assets by selected categories by all insured banks. And the basic point here is that the banks' holding of U.S. Government obligations has gone up dramatically in the last 2 or 3 years, and the percentage of commercial and industrial loans has gone down.

We see there in 1990 a 58 percent increase in government securities; in 1991, 91 percent; 1992, 74 percent increase. And commercial and industrial loans, which is what we are talking about, dropped in each of those 3 years it dropped; 3.5 percent in first year, 26 percent in the second, and 20 percent in the third.

From your testimony I gather—and I want to clarify it—that part of what you see in the credit crunch is a reaction to the economic cycle we have been through. Part of it, although I think you diminished the role maybe in your statement, may be the role of the Basle standards and the capital requirements, and then a larger part may be the regulatory burden on the banks.

A small businessman said to me back home in Connecticut, "Why should a bank loan to me? They get our money, give us 3 percent these days because of the low interest rates. They can turn around, put it in a mid-term government security and get 6 percent. No risk, no regulatory burden, no capital requirement. Why lend me any money?"

I would like to ask you to respond to the numbers included in the chart and respond to the statement that this small businessman made to me. Part of it really is, to what extent have we been the problem? That is, we in government, by creating these incentives, made it so attractive for the banks to go into public securities and not so attractive to make loans to small businesses.

Mr. MULLINS. There are a lot of questions there, Senator. One thing, to put this in perspective, is to think about a bank's portfolio and how much is invested in securities versus total loans. Fifty years ago today, the average bank had 20 percent of its assets in loans and 60 percent in securities. That was during World War II. They brought it down to 50 percent of the assets in securities and 30 percent in loans, and over the decades since, the level of loans has actually risen and peaked out at 62 percent of total assets, and securities bottomed out at 18 percent of assets in 1990. And, just recently, what we are seeing here is a tick up to 22 percent.

So one thing to keep in mind is the banks, in terms of their total loans, are down from 62 percent of their assets to 58.5 percent. But even at 58.5 percent, that is more to lending in percentage terms than they have had at any time in their histories except for this late 1980s period.

Senator LIEBERMAN. I appreciate the answer and I apologize for interrupting. One thing that strikes me, as we talk about the stimulus package that the administration has recommended—and it de-

pends on how you count it, $15 billion or $30 billion—here on these numbers we are seeing in the last couple of years a drop-off of $20 billion and then $26 billion a year in commercial and industrial loans and an increase of $91 billion in one year and $74 billion in the purchase of government securities. So the numbers are quite large.

Mr. MULLINS. These percentage changes may be small and the absolute numbers are large.

The other notable factor is C&I loans as a percentage of bank lending have gone down. All during the 1980s they have gone down as a percentage of bank lending. And then, in the early 1990s, C&I loans as a percentage of bank total lending dropped more dramatically.

So I think the most notable trend is that bank lending is shifting more toward consumer loans and mortgages. A goodly portion of those U.S. Government obligations are not Treasury securities. Banks have now less than 10 percent of their assets in U.S. Treasuries. The major part of the increase has been in mortgage-backed securities and other U.S. Government agency securities, which is another form of lending.

Now, if you ask me why a bank would be so attracted to putting its assets into mortgaged-back securities versus C&I loans, when you think of the regulatory burden and the examiner scrutiny and the forms to be filled out in investing money in a small business loans with unaudited financial statements versus putting it in a mortgaged-backed security or a standardized mortgage, then I think it is pretty clear that the regulatory system has tended to bias lending decisions more toward mortgages, mortgage-backed securities, consumer loans, the things that are easily standardized and mechanized.

Senator LIEBERMAN. Thank you. I think that is a very important point that, perhaps inadvertently and maybe for good reasons, but nonetheless, the government regulatory climate—and not just the climate, the specific actions—has created a system of incentives that has encouraged banks to not make loans to small businesses.

I am going to yield, with Senator Burns' understanding, to the ranking Member, Senator Pressler. I will only make that mistake once, Conrad.

Senator PRESSLER. Let me ask a question about this report. This is a report that the Federal Reserve commissioned, as I understand it and it is titled, "Bank Regulation and the Credit Crunch," by Joe Peak and Eric Rosengreen. This report concluded that the regulatory burden does tighten up credit substantially and does make it much harder for small business to get loans. Are you generally familiar with that report?

Mr. MULLINS. I am generally familiar with that line of research. We have had a number of papers.

Senator PRESSLER. Do you contract out for these reports?

How do these come about?

Mr. MULLINS. No. I think, one of the researchers is a staff member at the Federal Reserve Bank of Boston. And the other is a faculty member at Boston College.

Senator PRESSLER. OK. So this was written independently of the bank.

Mr. MULLINS. Yes. These are economists who write academic papers. And they have written a number of papers along that line.

Senator PRESSLER. Does the Board of Governors support the findings of this report?

Mr. MULLINS. We think they are interesting findings. What they find is that weak banks do not make loans, and there is a question of what one can do about that. One concern is that with the seemingly attractive alternative, when you have a weak bank, of saying, "Just go ahead; we will encourage you to lend," our experience with that has been a disaster in the S&L industry and the banking industry.

I do think there is a serious issue, though, in the sense of how much pressure you put on weak institutions to improve, and how fast. And we have a number of examples now that we are studying. We have the Midwest in the 1980s, and we have Texas, and we have New England. And so we are gathering data on this question of how much regulatory pressure is appropriate and how much regulatory pressure to improve might actually make things worse. And this sort of research is an input into that analysis.

Senator PRESSLER. What can the Federal Reserve Bank do about this problem? Or put another way, what agency or office can do something about it? Who has the power to make change?

Mr. MULLINS. Well, I think there are a number of things we can do. I think a lot of it will have to do with regulatory actions, such as the ones we are working on with the Administration, in which we can loosen some of the rigidity of the regulation that has come out in recent years.

Senator PRESSLER. Who does that? Who has the power to do that?

Mr. MULLINS. The Federal banking agencies. We think we have a fair amount of discretion with the current statutory framework.

Senator PRESSLER. So that can happen without legislation; you can do it administratively.

Mr. MULLINS. Yes, I think that can happen without legislation.

Senator PRESSLER. Will it happen?

Mr. MULLINS. I think it will happen.

Senator PRESSLER. In the next 3 or 4 months?

Mr. MULLINS. The exact timing of the work we are doing with the Administration is unclear, but I would not be surprised to see an announcement in the relatively near future and implementation in the next few months.

Senator PRESSLER. Is there anything we in Congress should do? Should we be urging speed or should we just wait for the report, if it is underway?

Mr. MULLINS. I think it is pretty close.

Senator PRESSLER. Let me ask you this, to change the subject. Lending institutions seem to have reacted differently to this recession as compared with previous business downturns. Lending actually has decreased, and the amount of investment securities held by banks is steadily increasing.

What conditions have made this recession different, and what does that mean for small business lending in the future?

Mr. MULLINS. I think there are a couple of areas of difference here. First, this is not a traditional recession in the sense of the economy just overheating and people having excess inventories. A

major part of this cycle had to do with the build-up of debt in the 1980s, which was unsustainably high, and then the reversal of that. That gave the banks record volumes of nonperforming loans, of bad loans, and this is why they have been absolutely absorbed with trying to fight for their financial viability and to build their capital. And in this environment they are not very aggressive in making the loans and, instead, have increasing incentive to park the money in securities.

The other thing that happened which was almost coincidental is that we did have these major changes in regulation in FIRREA and FDICIA, which came just as we were going through this economic cycle. For FDICIA, I'll give you an example. It was passed, as I recall, in November of 1991. Immediately, we had hundreds of regulations to write. We had to put together 60 working groups in each agency to write those regulations. For over a year we have been turning those regulations out.

The banking industry knew that was coming. And what banker in 1992 would launch a major lending initiative before they knew the rules and regulations, the specific rules, that would apply to that? So even the process of laying out this new regulation, in my opinion, may have had a chilling effect on the aggressiveness of lending over this period of time.

And it was tougher on small business loans because these are the complex heterogeneous loans, the ones that do not fit neatly into the standardized mode.

Senator PRESSLER. Right. Do you consider the current recession over?

Mr. MULLINS. By traditional economists' numbers, the current recession is over. In terms of this restructuring that we are going through, it is not yet entirely complete. The pressures of restructuring have abated, but one can clearly see the refinancing, the restructuring, still going on.

Senator PRESSLER. To return to my original line of questioning, could you give us an outline of the regulatory reform plan that is going to be issued? I know that President Clinton, Federal Reserve Chairman Greenspan and you all have mentioned that any day now we are going to pick up the Washington Post with our coffee and read about this great reform that is going to be done administratively. Could you give us an outline of what that will say?

Mr. MULLINS. I think it is premature to try to outline any sort of specifics here, but I think it is clear that our objective is to try to identify the major impediments, both bank regulatory impediments in general and specific impediments to small business lending. When you think of those, we have done a lot of work on what those are. We have senior loan officer surveys at the Federal Reserve. For example, 80 percent of them in the last survey said the FIRREA real estate appraisal regulations were a problem and a problem for small business loans. So that is an obvious one. And these real estate appraisal regulations were set up for commercial real estate problems. But many small businesses put up real estate as collateral for their business loan, even though the purpose is not really a real estate loan, and they have gotten ensnared by these regulations. We are going through a systematic review of all of

these regulations to try to come out with a set of actions which we believe can make a difference.

Now, I might just add that the Exam Council, which is a group of all the Federal regulators, is also working on legislative suggestions, statutory changes, which they think will help. I think we can make substantial progress with just regulatory action.

Senator PRESSLER. My time is up. You might answer this for the record. What can we learn from previous recessions? For instance, did this one have unique characteristics? From an economist's point of view, what do we expect next? Are we going to have prosperity? Are things going to be pretty level? What sorts of things should we be doing to prepare for the next phase?

Mr. MULLINS. I will be happy to answer that one for the record because I think the general outlook is encouraging.

[Responses to questions by David Mullins follows:]

FEDERAL RESERVE SYSTEM,
DAVID W. MULLINS, JR., VICE CHAIRMAN,
June 7, 1993.

The Honorable DALE BUMPERS,
Chairman, Committee on Small Business,
United States Senate,
Washington, DC 20510

Dear Mr. Chairman. I am enclosing my follow-up responses to questions posed at the Committee's hearing on March 4 on credit availability.

I hope this is helpful. Please let me know if I can be a further assistance.

Sincerely,

David W. Mullins.

Enclosure

Question. What can we learn from previous recessions? If this one had unique characteristics, or if this one did not have unique characteristics. But what can we expect? From an economist's point of view, what do we expect next? Are we going to have prosperity? Are things going to be pretty level? What shorts of things should we be doing to prepare for the next phase?

Answer. No two recessions are ever alike, either in the aggregate or in the detail, and a full accounting of the unique characteristics of any particular one would be quite lengthy.

That said, there are certain aspects of the most recent recession that deserve special mention. Foremost among these are the unusual headwinds that have been working to retard growth. Cutbacks in the defense industry, severe weakness in the commercial real estate markets, unusual caution among financial intermediaries, extensive structural changes that are being implemented by many large businesses, and the efforts of businesses and households alike to put their finances back on sounder footing have all played big roles in shaping the course of the most recent business cycle.

To some extent, the restraining effects of those headwinds were starting to become apparent in 1989, well before the actual start of the most recent recession in the third quarter of 1990. Similarly, their effects have persisted well into the current recovery, which, according to the designation of the national Bureau of Economic Research, began in the spring of 1991. The actual recession thus stands out as a relatively brief period of contraction overlaid on an unusually long period of slow growth, with the shape of the contraction itself probably influenced to a considerable degree by the rise and fall of oil prices that followed the Iraqi invasion of Kuwait.

The Federal Reserve began to east monetary conditions in 1989, as the slowing of the economy became evident in the incoming economic data. By the start of the recession in mid-1990, short-term interest rates had come down considerably. Additional steps toward greater ease of money market conditions were taken during the recession, and still more steps were taken in 1991 and 1992, as the economy struggled to make progress against the headwinds. Gains came slowly at first. Growth of

real GDP was positive in each of the last three quarters of 1991, but, on average, amounted to only about 1¼ percent at an annual rate.

Last year brought stronger gains. Activity accelerated over the course of 1992, and the rise of real GDP during the year cumulated to 3.1 percent, the largest advance since 1988. The headwinds apparently lost a little of their force in 1992. In addition, many sectors of the economy—such as housing, autos and other consumer durables, and business fixed investment—continued to benefit from reductions in interest rates.

By the final quarter of last year, growth of real GDP had accelerated to a pace of 4¾ percent. However, that rate of growth was clearly unsustainable, as the headwinds, while no longer at gale force, have by no means fully abated. Defense spending contracted at an especially rapid pace in the first quarter of this year. In addition, structural adjustments have continued in many large businesses, and a number of foreign industrial economies still are experiencing slow groth or recession. These influences, coupled with the effects of the late winter storm, held the growth of real GDP to less than 1 percent at an annual rate in the first quarter of 1993.

But, looking through the quarterly ups an downs in the rate of growth, the mechanisms of sustainable expansion still seem to be in place. Payroll employment has risen about 900,000 since the end of 1992, and the incoming data on production, orders, and sales, while not uniformly positive, suggest that the expansion still is solidly on course. In February, the FOMC members and other Reserve Bank Presidents were anticipating that economic growth over the four quarters of 1993 would be in the range of 2½ to 4 percent, with a central tendency of about 3 to 3¼ percent. (These forecasts were included in the Board's February 14, 1993, Monetary Policy Report to the Congress and are reproduced in the table below.) In view of the weak first quarter, an outcome in line with the central tendency may be more difficult to achieve, but an outcome within the broader range still is not unlikely, especially given the gains in activity that seem to be implied by the May labor market report.

ECONOMIC PROJECTIONS FOR 1993

Measure	Memo: 1992 actual	FOMC members and other FRB presidents	
		Range	Central tendency
Percentage change, fourth quarter to fourth quarter			
Nominal GDP	5.4	5¼ to 6¼	5½ to 6
Real GDP	2.9	2½ to 4	3 to 3¼
Consumer price index [1]	3.1	2½ to 3	2½ to 2¾
Average level in the fourth quarter, percent [2]			
Unemployment rate	7.3	6½ to 7	6¾ to 7

[1] CPI for all urban consumers.
[2] Percentage of the civilian labor force.

Senator LIEBERMAN. Thank you, Senator Pressler. The Chairman has graciously yielded to those who came before him and we will go now to Senator Wofford.

Senator WOFFORD. Do you anticipate that the Federal Reserve will recommend any legislative changes after this review that is going forward?

Mr. MULLINS. Our prime focus has been on regulatory changes which can be implemented immediately. One of the reasons is because all the banking agencies, under the Federal Financial Institutions Examination Council, have been at work on a project first

of identifying regulatory burdens and they presented a report not long ago on that, and now they are at work on a separate program to try to eliminate statutory burdens.

The problem, Senator Wofford, is not just one statute or one section of a statute which says one must document every small business loan; it is a whole web of statutes. We have loan-to-value requirements. Those require documentation. We have auditing requirements. What do auditors do? They look for documentation. Internal control requirements. So we have a whole web of statutory arrangements which tend to push toward this documentation.

We think we can make substantial progress in this interagency group with the Administration with regulatory action, and then the Exam Council, probably in May I think, will release detailed analyses of what statutory changes they would recommend.

Senator WOFFORD. As you are aware, there are geographic areas; notably, inner cities and rural communities, many of them, that have had real credit problems long before the recession. I wonder if you have any thoughts on what might be done to deal with those longer-term problems.

Mr. MULLINS. Well, I know it is a priority of the new Administration and they have suggested a number of approaches including community development banks. We are not yet at a level of specificity on those proposals to evaluate them. But clearly, the flow of credit to those communities is a fundamental determinate of their economic progress, and one cannot expect communities to prosper without such a flow.

Senator WOFFORD. Thank you for your testimony.

Senator LIEBERMAN. Thank you, Senator Wofford.

Senator Burns.

Senator BURNS. I guess I just have one question, Mr. Mullins. I want to hear from the banker from Arkansas.

When you go through this inventory that you are going through now, reviewing some places where rules and regulations can be changed, I would have some concerns, I guess, if those rules and regulations were created as a result of legislation and then changed at the regulatory level without any legislative review. I think I would have some problems with that.

Will we be presented with those suggested changes and some sort of oversight either by this Committee or the Banking Committee before actions are taken?

Mr. MULLINS. I think many of these actions will require that we put out regulations for public comment and go through the full process.

If I might comment on the premise, we are limited by these statutes, but what has happened is that the statutes are having unintended effects. I hate to continue to criticize the FIRREA real estate appraisal statute, because that was a very worthwhile component because of all the problems with commercial real estate. But it never occurred to people that if I am going to borrow for my small business and I put up collateral just to make it a little safer loan, that somehow I am ensnared in that regulation.

So what we have done is to try to see where the regulations may have had unintended effects, and we will go through the full proc-

ess of making those recommendations public by going through the public comment periods.

The other thing I would mention is that our feeling is that the industry does have a sound capital position. At least some of these changes may be available only to well-capitalized, well-rated, strong institutions in order to protect safety and soundness, and we do have discretion in the statutes for some of this.

Senator BURNS. Well, you can take a look at everything, where they have gone with their money rather than going into the loan market. It does not take a rocket scientist to figure all that out. And I appreciate that. But I just had some concerns over the inventory that you are doing now.

Thank you, Mr. Chairman.

Senator LIEBERMAN. Thank you, Senator Burns. I think Senator Levin was next.

Senator LEVIN. Thank you, Mr. Chairman. Welcome, Mr. Mullins.

What percentage of the over-regulation problem is caused by regulation that can be cured by changes in regulation, and what percentage requires statutory change? You have talked a lot about we do not have to change statutes in order to make progress. Can we cure two-thirds of this problem through the regulatory change, or is it some other proportion?

Mr. MULLINS. I think it is quite difficult to estimate, although one thing is clear. The fundamentals underlying these loan markets are much improved, so things are going in the right direction. This is what makes us believe that with some very well-targeted, specific regulatory actions, we can make a significant difference.

Senator LEVIN. Would you say that we can go more than halfway in the direction?

Mr. MULLINS. I would say we would certainly hope that we could be in the neighborhood of halfway.

Senator LEVIN. Can you give us some examples, even though you don't want to give us the outline and that is understandable? You have said that there will be a recommendation perhaps within a month or so, I believe. Is that about the right timeframe?

Mr. MULLINS. Yes.

Senator LEVIN. Can you give us just an example or two of what you might do in this area without saying you are going to? Just make it real for us.

Mr. MULLINS. I can talk about perhaps some of the proposals that have been discussed in the public debate.

Senator LEVIN. That would be fine. Which one has a lot of support, without saying you are going to adopt it?

Mr. MULLINS. Again, on the FIRREA appraisal requirement——

Senator LEVIN. No. In the regulatory area.

Mr. MULLINS. Well, this is part of it.

Senator LEVIN. That can be cured by regulation?

Mr. MULLINS. Yes. That can be cured by regulation because it is an interpretation of that statute. And what you might say, for example, is that it should not apply to loans which are not made for the purpose of buying real estate or carrying real estate. If the collateral is simply put up for a business loan as an extra safety

measure, then you do not have to go through the full appraisal process.

The other thing one might say, for example, which has been talked about in the public press, is for a well-capitalized institution you might specify that up to some percentage of your capital we will allow you to invest with customers whom you have known a long time, whom you are confident of, with very little documentation. We trust you on these for a limited amount. I mean, we do this with consumer loans.

I got a credit card probably 25 years ago in graduate school and I filled out one application. They raised my credit line each year—or did until I got into government——

[Laughter.]

No new applications and no new documentation.

So there is a question of can we create this haven from increased documentation which could be focused on small business lending. That is another one which has been discussed. People also have discussed a variety of accounting issues and some of our examination process issues as well.

The other thing I would just mention about this approach is, in my opinion, it is not an attempt to produce the longest laundry list we can come up with. And, in fact, I am a little concerned, given that our Chairman has talked about it and has gotten a lot of press, that some people may think it is not as long a list as it conceivably could be. The effort has been not to look like we are doing a lot, but to focus instead on the factors which we believe are really having an impact and, so on the few factors where we think we can make a substantial impact. So it has been a focus on depth. And I think we are pretty encouraged with the process, Senator.

Senator LEVIN. I want to encourage you to move in the direction you are going and add my voice to the others. Small business has really taken it on the chin, and it is bad enough that we have had a recession which has dragged on this long. But the regulatory burdens, the excessive burdens, that we placed on the banking system loans to small business has been absolutely harmful. It has pushed many small businesses under needlessly, and I would like to encourage you to move in that direction.

There is always some political risk in that because some day somebody might say, well, you deregulated too much. But I think that is a risk that we have to take. If we do it right and with the right protections in it, it is worth taking for the sake of getting small businesses as healthy as they have a right to be. Because, as Senator Lieberman and others have pointed out, they are the big generators of jobs in this country.

I just want to ask one question about where the residential loans fit on that chart.

Mr. MULLINS. They are not included. A good portion are not included. You would add, for example, consumer loans, and you could break out mortgage-related securities from U.S. Government obligations. Perhaps more than half of the growth in U.S. Government obligations has been in the mortgage market through standardized mortgage instruments, such as bonds and CMOs issued by FNMA and FHLMC.

Senator LEVIN. Is that your chart?

Mr. MULLINS. No.

Senator LEVIN. I wonder if you could give us a chart that includes the figure on those other categories, because I think that is important. My time is up. Thank you.

[Responses to questions and chart requested follow:]

Question. Where do residential mortgage loans fit on that chart? Could you give us a chart that includes figures on other components?

Answer. The attached chart shows the net change in assets for domestically chartered commercial banks in the United States. The figures are from the Federal Reserve Board's Flow of Funds accounts, based on data from banks' Reports of Condition.

In the chart, acquisitions of U.S. Government Obligations have been broken down into two categories: column 2 comprises Treasury and a small amount of budget agency securities; column 3 comprises mortgage-backed securities and collateralized mortgage obligations. As can be seen in the table, acquisitions of mortgage-related securities (column 3) accounted for more than 40 percent of the increase in U.S. government obligations at insured banks in 1991 and 1992. Investments in mortgage-related securities provide funds to mortgage markets just as do mortgage loans. Thus, column 10 provides a more comprehensive measure of total residential mortgage lending by banks, which is the sum of acquisitions of mortgage-related securities (column 3) and net change in residential loans (column 9).

The table also includes the change in consumer loans at banks (column 7). The contraction in this component in 1991 and 1992 largely reflects the securitization of consumer loans originated by banks and taken off their books. On net, an estimated $16 billion of consumer loans were securitized by banks in 1991, and $10 billion were securitized in 1992.

The table is on the following page.

NET CHANGE IN ASSETS FOR DOMESTICALLY-CHARTERED COMMERCIAL BANKS IN THE U.S.

(Billions of dollars)

	Total [1]	U.S. government obligations		State and local bonds	Corporate bonds	Commercial and industrial loans	Consumer loans	Commercial real estate	Residential (family) real estate [4]	Memo: Total residential real estate lending [5]
		Treasury [2]	Mtg-backed [3]							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1980	131.4	25.0 [6]	....	13.2	0.5	25.1	−6.2	5.2	10.9	10.9
1981	134.1	11.4 [7]	....	5.7	0	38.7	4.0	9.7	9.8	9.8
1982	145.9	26.7 [8]	....	4.6	1.7	42.4	6.7	12.1	2.9	2.9
1983	147.8	44.2 [9]	....	3.8	3.6	17.1	22.7	19.7	8.7	8.7
1984	184.0	5.5	−4.2	12.6	3.2	52.6	45.2	30.5	12.8	8.6
1985	220.8	7.0	−2.4	57.2	2.3	22.9	37.5	31.0	17.2	14.7
1986	215.1	16.7	25.7	−28.4	15.0	40.2	24.8	45.7	23.2	48.9
1987	46.2	2.6	22.3	−29.1	20.6	−5.1	16.5	41.8	37.4	59.6
1988	137.0	5.0	14.8	−22.7	13.0	18.7	33.1	30.2	37.1	51.9
1989	188.1	−2.5	36.5	−17.8	2.0	17.7	21.2	33.5	51.2	87.7
1990	100.2	9.7	44.8	−16.4	3.9	−5.6	1.7	−4.5	66.0	110.7
1991	36.1	53.0	43.6	−14.1	4.0	−49.8	−13.5	−9.2	31.0	74.6
1992	81.7	50.5	35.3	−5.6	−3.5	−19.6	−8.6	−6.0	25.1	60.4

Note: Data do not add up to net change in assets because other asset categories are excluded.

[1] Unearned income, allowance for loan and lease losses, and allocated transfer risk reserve have not been netted out of the total loans included in total assets or any of the loan components shown separately.

[2] Includes Treasury issues and a small amount of budget agency securities.

[3] Holdings of U.S. government-issues or guaranteed certificates of participation in pools of residential mortgages (shown separately beginning 1984) and collateralized mortgage obligations issued by FNMA and FHLMC (shown separately beginning 1990).

[4] Includes loans secured by 1 to 4 family residential properties, construction and land development loans that are estimated to be associated with residential development, and private certificates of participation in pools of residential mortgages.

[5] Column 9 plus federally related mortgage-backed securities plus collateralized mortgage obligations (including REMICs) issued by FNMA and FHLMC (column 3).

[6] Represents total of column 2 and column 3 for the year 1980.

[7] Represents total of column 2 and column 3 for the year 1981.

[8] Represents total of column 2 and column 3 for the year 1982.

[9] Represents total of column 2 and column 3 for the year 1983.

Senator LIEBERMAN. For the record, that chart is based on FDIC data.

Senator Coverdell.

Senator COVERDELL. Thank you, Mr. Chairman.

Mr. Mullins, have you any numbers that calculate the cost to the system of these regulations we are now trying to identify? What has been the total impact of this exercise we have been going through?

Mr. MULLINS. The study by the Examination Council, which is the coordinating committee of the Federal banking agencies, estimates $10 billion to $17 billion as the cost to the industry. I would point out that there could be higher cost because that is the cost inside these banks. If we raise the cost of credit and reduce the availability, then we have had a cost outside the banking system, the cost of those businesses who were not able to expand.

Senator COVERDELL. So, on an annual basis, $10 billion to $17 billion within the industry not dealing with the extended costs, societal.

Mr. MULLINS. Yes, sir.

Senator COVERDELL. What percent of their total operating expense would that be—can you relate that to percentage? My community of bankers have indicated 10 percent.

Mr. MULLINS. It is about 14 percent of their total noninterest expense. In other words, of their total organizational expenses, it is about 14 percent, 15 percent, on that order of magnitude.

Senator COVERDELL. In other words, extremely significant.

Mr. MULLINS. It is a significant factor.

Senator COVERDELL. That leads me to a final question.

To some extent—and I do not think anybody has really intended it to be that way, but to some extent there is an implication that there is a surprise impact by some of the recent regulation and recent legislative imposition on the industry. This cannot be categorized as a surprise. The industry and consumers at large, for years have been saying there is this implied result if we continue in this vein.

How have we come to this? As I just said, it cannot be considered a surprise.

Mr. MULLINS. Between the years 1940 and 1980, 200 banks failed, approximately five a year. Between 1980 and 1985, 200 banks failed, 40 a year. Since 1985, approximately 200 a year failed. And we had the S&L crisis.

I think we started to see the change in the mid-1980s with the increased failure rates, and then it culminated in these two very large statutes, FIRREA and FDICIA, which, unfortunately, coincided with this economic cycle. And it was a gradual build-up in change in regulatory philosophy.

The last lunge into FIRREA and FDICIA has been driven by the S&L cost to the taxpayer. What these statutes do to the banking industry is they say, "Get safe, get away from the edge, get away from the taxpayer's pocket book." And that is what the industry has been doing over the past couple of years, which has adversely affected credit availability.

Senator COVERDELL. In your calculations, in your endeavor to retrench, so to speak, have you established a cost equivalent associat-

ed with a reduction of the $10 billion to $17 billion? Is that a factor in your analysis? Is there a goal to make that $5 billion to $8 billion?

Mr. MULLINS. Yes. I think, obviously, the objective is to try to get it as low as possible consistent with safety and soundness. Now, the payoff to having the high capital the banking industry has now is that that protects the taxpayer.

And so our concern is that we do not need all these cumbersome other regulations if an industry has strong capital. Perhaps for institutions that are very weak, we have to go in and look at them carefully. But for the majority of the institutions who are very strongly capitalized, they have their own money at risk, they know what they are doing, and they have been successful for 100 years Our objective is to try to reduce that burden on them but still keep an eye on their safety and soundness and their capitalization.

Senator COVERDELL. You commented on the standardization being almost incongruous with the nature of lending to small businesses and I agree entirely, and I would only suggest that to the extent you can emphasize judgmental value in the small business, it must be highly, highly emphasized. Thank you for your testimony.

Senator LIEBERMAN. Thank you, Senator Coverdell.

We now come to our beloved and heroic chairman, the Senator from Arkansas, Dale Bumpers.

The CHAIRMAN. First of all, I want to thank Senator Lieberman for very ably filling in for me this morning. It was a real question as to whether or not I was going to get out in this weather. We are not going to be able to muster a quorum in the Senate much longer if people keep coming down with what I had.

David, welcome. It is good to see you again, and the point has already been made that David's father and mother were very dear friends of mine, a great president of our university. And I followed David's career, which has also been exemplary.

I will tell you one interesting credit card story about the President of the American Banking Association, who is with us this morning, Bill Brandon. He was telling a friend that his wife, Lainie—who is a beautiful, dear woman. He is badly over-married——

[Laughter.]

That Lainie got her credit card stolen. And the guy said, "Did you report it?" And Bill said, "No." And he said, "Why not?" And he said, "Because the guy who stole them ain't spending as much as Lainie was."

[Laughter.]

[The prepared statement of Senator Bumpers follows:]

PREPARED STATEMENT OF HON. DALE BUMPERS

The Small Business Committee has convened this morning to examine the availability of credit for small business. During the recession of recent years, even the healthiest small businesses have had a difficult time obtaining credit in spite of declining interest rates. Increased regulations on lenders, increased capital reserve requirements, low interest rates and the increased risks associated with small business loans have all been cited as factors discouraging small business lending. At the same time lenders seem to be increasingly investing in government securities rather

68-234 O - 93 - 2

than making loans to small businesses. It goes without saying that this trend is not helpful to economic recovery.

Another troubling aspect for many small businesses is the demise of the so-called "character loan". In this increasingly tight regulatory environment, lenders can no longer use their discretion to make a loan to an individual or business when, despite weak collateral or ratios, the lender knows the borrower's reputation in the community and knows the borrower is likely to repay the loan.

Our witnesses this morning will provide a variety of perspectives on the problem of credit availability for small business. They represent the Federal Reserve, two bank associations, an association of commercial lending officers, and a small business, whose President has had first-hand experience with the credit crunch. I welcome you, gentlemen, and thank you for your informative statements.

I look forward to hearing your views on the reasons for the credit crunch, the disappearance of character loans and other issues affecting credit availability for small business. In addition, the Committee is interested in hearing your suggestions on changes that could be made to encourage lending to small businesses. This will be increasingly important as the economy moves out of the recession.

Your full written statements will be included in the hearing record, as will several statements that have been submitted by other interested parties. In the interest of allowing more time for questions, I encourage you to summarize your full statements.

Mr. Mullins, please proceed.

The CHAIRMAN. Let me ask you a question that has not been asked this morning. You probably saw the Post this morning and you saw where the Supreme Court yesterday put a damper on the use of RICO, the racketeering statute. I have always felt that that has been one of the most abused laws.

We passed that to get at genuine racketeers. It has turned out to be a trial lawyer's dream. And you can force people to settlement because you can demand a million dollars' worth of copying of documents, if you are a plaintiff suing a broker or a banker and so on.

First of all, do you agree with that Supreme Court decision, just based on what you know about it?

Mr. MULLINS. Based upon what I know about it, I think we would. We have a whole area here of lender liability, and in the environmental area in particular, which has just been a major problem. And again, it is a problem which will afflict a small business loan but not a Fannie Mae or a typical mortgage or credit card loan.

The CHAIRMAN. Incidentally, that case originated in Van Buren, AR, and it is just a few miles from my home. I knew the case. The guy built a gasohol plant. I knew the case but I did not realize it was coming up at the Supreme Court.

I have voted every time it has come up since I have been in the Senate to let up on RICO because, as I say, it is being abused. But the other thing is, you know, lending institutions have two goals: maximize profit, minimize risk. Our goal really in this hearing this morning and the principal goal of this Committee is always, simply to make small business more attractive to the capital market. Everybody who comes in here from the small business community will tell you that their biggest problem is the credit crunch; they cannot get money.

So my question is: We have this tremendous demand right now for 7(a) loans, guaranteed loans. President Clinton is suggesting that perhaps we ought to reduce the guaranteed portion to about 75 percent. What, if any, effect do you think that would have? Would that have a dampening effect on 7(a) loans?

Mr. MULLINS. We could take a look at that issue and study it. I do not know that it would, if it could increase the supply. I think it might not be a bad idea to ease off on the guarantee a little bit, and I do not think it would have a material impact of making it more unattractive.

The CHAIRMAN. As you know, the demand for 7(a) loans is just growing exponentially. We had a 35 percent increase in 1992 over 1991; the first 4 months of 1993 there is a 27 percent increase of 1992, and I do not see any let-up because banks are very anxious to make these kinds of loans because of the guaranteed portion of it. And I am reluctant to go to a 75 percent guarantee if it is going to have a dampening effect, and that is the reason I wanted to know what——

Mr. MULLINS. I can have some of our technical people who follow these areas very closely see if they can do an analysis as well, but on the face of it, I doubt that it would have a dampening effect. Of course, this is evidence of the restricted credit availability to small business.

[Responses to questions from Mr. Mullins follows:]

Question. What, if any, effect do you think reducing the guarantee by the SBA to 75 percent of loans would have? Would that have a dampening effect on 7(a) loans?

Answer. The law currently allows the SBA to guarantee up to 90 percent of loans to small businesses, with a cap of 80 percent for loans made under the agency's "preferred lender program" (selected lenders may approve SBA loans automatically). The agency can only guarantee loans up to $750,000, with the balance of larger loans remaining uninsured. The proposed change would lower the maximum allowable guarantee from 90 to 80 percent, and to 75 percent for preferred lender loans.

While the change might dampen growth of 7(a) loans, evidence suggests that the magnitude of this effect in the aggregate likely would not be large. In particular, a good portion of SBA loans—especially larger loans—apparently already fall below the proposed new standards. In implementing the law, SBA regulations allow up to the full 90 percent guarantee for loans of less than $155,000, but only 85 percent for larger loans, and 80 percent for loans in the preferred lender program. The SBA staff estimates that, in the aggregate, the agency currently guarantees 81 percent of outstanding SBA loans, an amount not far above the 75 percent average under the proposed change.

The cap reduction likely would have a somewhat greater impact on smaller loans in the 7(a) program, which typically are more risky and carry the largest guarantees. SBA data indicate that smaller loans (less than $250,000) accounted for less than one-third of loan approvals last year and their share has been declining since 1990. For a bank in a competitive market, expected revenue from a guaranteed loan depends on the probability of default, the proportion of principal and interest that is guaranteed by the government, the bank's cost of funds, and the fee charged for the government guarantee.

Some rough calculations provide an illustration of how the guarantee interacts with other terms to affect the bank's willingness to make the loan. The cost of the SBA guarantee is 2 percent of the principal, and assuming that the cost of funds to a bank is roughly 3 percent, the marginal cost of an SBA-guaranteed loan would be about 5 percent (assuming transactions costs are zero for the lender). If the probability of default is 10 percent, these calculations suggest that the bank would require at least a 6.1 percent interest rate on a loan with a 90 percent guarantee, while a loan with an 80 percent guarantee would require at least a 7.1 percent interest rate to cover its costs. Both of these rates compare favorably with the current maximum charge of 2¾ percentage points over the prime rate (now 6 percent) for SBA loans that are longer than 7 years. Moreover, the SBA allows banks to add a percentage point to the maximum markup for loans that are less than $50,000 and another point to loans that are less than $25,000. These add-ons recognize that the administrative costs per dollar will be much higher for very small loans and, hence, some compensation is required to make these loans attractive to banks. In this case, the lower guarantee shouldn't have much effect on the pricing and availability of SBA guaranteed loans. But the value of the guarantee increases with the probability of default; if the probability of default is assumed to be 20 percent, the bank would

need to charge an interest rate of almost 10 percent for a loan with an 80 percent guarantee in the same scenario, which could preclude the bank from profitably making the loan. Therefore, at the margin very risky loans may be affected.

The CHAIRMAN. David, you know, some people blame bankers and they say they are simply doing what bankers do: maximize profits. If you can buy bonds for 6 or 7 percent and pay your depositors 3 percent with no risk, they are doing that. I do not blame them for doing that. If I were a banker that is what I would be doing.

But my point is, how do you overcome that unless your regulations are going to do something to give them a greater incentive to loan? And in that connection, this is sort of a separate question but I want to ask it while I have it on my mind. We mentioned RICO a moment ago. Resolution Trust Corporation has hundreds of lawsuits pending all over America against officers and directors. I tell you, Bill Brandon could not get me to serve on his board, nor could any other banker. I would not go on a board and face that personal responsibility that the bankers of this country are being subjected to for anything. Does that have a dampening effect?

Mr. MULLINS. We are concerned about that and we are looking at that to see what we can do as well. I agree with you. Small banks or large banks, I do not see how they get directors in this day and age.

On your other point, Chairman Bumpers, I believe banks can only make a profit long term in lending, and I think that is what they are all about.

Now, in the current economic scenario, our evidence suggests that the average maturity of bank security holding is only between 2 and 3 years, so they are earning 4 percent or 5 percent on a Treasury security. If they made a small business loan at prime plus two or prime plus three, they could get 8 percent or 9 percent. Now, the extra capital they would have to put up for the business loan comes to about a half a percent off that yield.

It still looks as if that small business loan is a very profitable opportunity, and that is why we believe that one of the real impediments is not just that spread in rates. It is the fact that the lending officer has to fill out all those forms and the examiner will scrutinize them and there might be a lender liability issue involved on the property and you will have to pay—the average small business loan from our last survey was $25,000—plus the cost of appraisal requirements because someone is putting up a $100,000 piece of property.

So we think, ultimately, that banks will return to lending, but the question is, return to small business lending or not. They are returning to consumer lending. Look at the rates they are getting on consumer loans and credit card loans, and mortgage lending. It is the business lending which has been disadvantaged and where the growth has not returned. These other categories of lending turned around in September and October.

On consumer installment debt we were getting big negative numbers month by month, and it turned around in September with positive numbers since then. Small business loans have not turned around. This is why we believe some of these actions will help unleash the banks.

The CHAIRMAN. With the Committee's indulgence, let me just make one other point. You may or may not know, I have been championing a small business capital gains bill here for about 3 years. The President championed it, too, during the campaign, but what he came out with was at slight variance with what I had been championing. I watched a basketball game with him last night and I forgot to take this up with him.

But the genesis of that bill is simply to try to do anything we can do to make capital available to small business. It may not work. The truth of the matter is, if your banking regulations, the ones you are talking about now, if they come out and they make taking these risks more attractive, then the need for this capital gains bill would obviously be diminished.

But right now, I can tell you small business is desperate. I do not know where we are going to come out. The President wants to limit these companies to $25 million; mine was $100 million. You know, if you are in a high tech business $100 million is not a lot of money. So I do not know how we are going to resolve that.

Mr. MULLINS. I would support your proposal. I think it is a very good one, and it does need to be large enough to capture those companies that are developing into the leaders of tomorrow.

I also think it might be useful if it applied to Subchapter S corporations, for example, and that is another——

The CHAIRMAN. Yes. Absolutely essential.

Mr. MULLINS. That is another area, given the tax impact, since they look like high-income individuals, they are going to have a tough enough time.

The CHAIRMAN. Of course, you know, that is where most small businesses are, in Subchapter S, and it just makes no sense not to do that. But, David, I really genuinely appreciate your endorsement of that. I will also tell the President of your endorsement.

Thank you, Senator.

Senator LIEBERMAN. Thank you, Mr. Chairman.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Mullins, it seems to me that, in a way, you have to be a psychiatrist up here, because I think Congress has a severe case of schizophrenia. One week, they lambaste the banking regulators because of the atrocious things that have happened with S&L's. Hearings are held on the Community Reinvestment Act and the hearing room is packed as the banks are pilloried. Truth in lending is held up to the banks, and why don't you provide more documentation. The next week, the discussion is, "What is the matter with the banks? Why are they not lending to small businesses?"

Now, I notice that your chairman, Mr. Greenspan, has talked about targeting the paperwork burden, and indeed, the President himself has talked about that. The banks, as you know, are laden with all kinds of paperwork requirements, most of which we have imposed on them and most of which we in Congress supervise with some enthusiasm.

Now, Mr. Greenspan in his talk about reducing the paperwork burden did not get into any specifics, nor have you. Do you have any specifics on reducing the paperwork burden? And it seems to me that it would be helpful, at least as far as I am concerned, if

not only would you tell us what you are going to do through the regulatory process, but if you would tell us what we ought to do in the legislative process.

I mean, it is not beyond the realm of possibility to change some of these laws if they are really too onerous or contribute to the credit crunch. The tendency in Congress is not to change any law, as you know. There is a whole group of enthusiasts for every law that we pass around here—regardless of the potential damage to small business borrowers ,or other financial consumers.

[The prepared statement of Senator Chafee follows:]

PREPARED STATEMENT OF HON. JOHN N. CHAFEE

Thank you, Mr. Chairman. I am delighted to be here today for my first hearing as a member of the Small Business Committee. I want to thank you especially for scheduling todays hearing on the credit crunch, a problem that has been especially severe in my home state of Rhode Island.

As everyone knows, credit is the lifeblood of every business, both large and small. Businesses need capital to expand, to buy new equipment, to hire new employees. Today, however, virtually every small business owner in Rhode Island tells me that they can't get a bank loan. The same problems are occurring in Connecticut, in Massachusetts, and throughout much of the Nation.

When small businesses can't borrow, or there is the perception that banks don't want to lend, the entire economy suffers. In Rhode Island, there are nearly 25,000 small businesses, employing more than 300,000 workers. These businesses need credit to survive. Economists tell me that 70 percent of the new jobs in our Nation are expected to be created by small businesses—but I wonder if this will hold true in my state without permitting small businesses to obtain the credit they need to hire new workers.

In the past 2 years Rhode Island's small businesses have been hit hard—by the credit crunch, by the ill-conceived luxury tax on boats, by the steep decline in defense spending, and by a particularly harsh regional recession. The cumulative effect has been devastating. In 1991, there were 344 small business bankruptcies in Rhode Island—a whopping 215 percent increase from 1990! Figures are not yet complete for 1992, but estimates suggest that another 300 Rhode Island small businesses filed for bankruptcy last year.

Now, the credit crunch has not caused all of these small businesses to fail. But there seems to be a consensus that the lack of available credit is hampering efforts by small businesses to rebuild, and emerge from the recession. Studies published by National Federation of Independent Businesses (NFIB) and the Federal Reserve confirm that New England was the most troublesome region for small business borrowing between 1990–1992.

But studies only tell part of the story.

This past summer and fall, I held four public hearings to hear from Rhode Islanders about the condition of our economy. Almost every small business owner made it a point to tell me about the credit crunch. Just yesterday, I received a letter from a small business owner in Newport, Rhode Island who can't find a bank willing to make a loan to her business. Pamela Kelley, operates Rue De France, a successful mail-order company that sells French lace and other decorating products. Rue de France is a small business; it employs several dozen workers during peak periods of the year. Her business is profitable. But despite her success, banks in Rhode Island have refused her requests to borrow additional funding to expand her business—and create new jobs in the process.

Pam Kelley's story is all too typical. I believe that unless some decisive Federal action is taken quickly to end the credit crunch, the situation in Rhode Island situation could actually worsen in the coming months. I say this because two of our largest banks—Eastland Bank and Old Stone Bank, with combined assets of $2.5 billion—have failed recently. Both banks focused their lending efforts on small and medium sized businesses, and their absence from the market could create a serious credit vacuum for small businesses.

I was encouraged to hear last week that Federal Chairman Alan Greenspan has called for immediate Federal action to help "break the back of the credit crunch." President Clinton also seems interested in the problem. He pledged last week that regulators will soon implement new regulatory initiatives to encourage banks to make loans to creditworthy small business customers. I welcome these develop-

ments, and look forward to speedy federal action to address the credit crunch. Regulatory relief could go a long way toward ending the credit crunch.

Thank you Mr. Chairman, I look forward to hearing from today's witnesses. And I have several questions that I will address to the witnesses at the appropriate time.

Senator CHAFEE. But what specifics do you have, either regulatory or statutory?

Mr. MULLINS. On the statutory specifics, the Examination Council, the group of Federal regulators, will come out with a specific set of proposals for statutory changes. They have been studying this for a number of months.

Senator CHAFEE. When will that be?

Mr. MULLINS. That will be in May of this year.

Senator CHAFEE. That deals with the paperwork burdens—both regulatory and legislative burdens?

Mr. MULLINS. Well, that deals with the statutes, what laws you would change.

Now, in terms of dealing with the paperwork, we think we can make some progress without statutory change. And again, I think the banking agencies and the Administration have not made a final decision, but I will give you one example. Again, on small business loans, why shouldn't a well-capitalized, strong, well-rated bank be able to make small business loans that they feel comfortable in, requiring whatever they need to feel comfortable, at least up to a certain limit or for a certain percentage of capital or something of that nature.

The regulator would look at the portfolio, just like a credit card portfolio or a consumer loan portfolio, but we would eliminate all regulatory documentation. That's a character loan. And you would watch the portfolio, and if it got in trouble you would be in trouble. But one thing we could do is simply to say, for well-capitalized, well-rated institutions for a certain limited amount, we are going to say we trust you for that amount. We will let you decide what documentation you think you need to make that lending decision, instead of having it specified here in Washington.

Senator CHAFEE. During the past several years when we have had hundreds of bank failures—and, indeed, in the Northeast apparently they are not over with—did the regulators, usually find there were very good warning signals a year, 6 months before the bank failed? Or were regulators caught totally by surprise when what they thought was a well-capitalized bank suddenly was in terrible trouble? Are there warning signals usually when a bank gets in trouble?

Mr. MULLINS. I think we have learned a lot about that.

As I mentioned, we essentially did not have bank failures until the mid-1980s and so we were not very sophisticated.

And I think we had a number of institutions that did not have enough capital.

Now, we do, I think, have a pretty good early warning system. A lot of these failures we had in the late 1980s and early 1990s, though, I think did take us by surprise. But it was not just that they were poorly-managed institutions. This little price boom that we had in Boston real estate from the mid-1980s, as you recall, through 1989, that just took up the value of all the property above sensible economic values; and banks, doing their normal business,

made those loans, and then the values dropped from underneath them.

This happened, as the Senator mentioned, in the Midwest and it happened in Arkansas as well with agricultural land prices in the 1980s. They just went up and then collapsed. In Texas, we had the situation with the oil prices. The Texas institutions, the Texas commercial banks, were the best-capitalized commercial banks in the country going into that period. Now, the problem is the entire economy was tied to those oil prices, and so a number of them failed. They were still, of course, much better off than the S&L's there who did not have any capital.

But this is one of the things that I think is different about this cycle, that we have had a worldwide period of bubbles of asset price inflation and collapses. And we see it in Sweden and the Nordic countries, we see it in Australia, Japan, and the U.K. A large percentage of the home mortgages are under water in the U.K. And this came from this period of the 1980s when debt and asset prices simply got out of control and it has caused an economic downturn in many, if not most, industrialized countries.

Senator CHAFEE. Thank you, Mr. Chairman. The purpose of the question was that if you make these character loans to well-capitalized institutions and things go sour, you will get a warning signal, presumably, under what you have learned over the past several years.

Senator LIEBERMAN. Thank you, Senator Chafee.

Senator Heflin, I believe you were next.

Senator HEFLIN. Thank you. Most of my questions relative to small business have been asked. I ask that my prepared remarks be included in the record.

[The prepared statement of Senator Heflin follows:]

PREPARED STATEMENT OF HON. HOWELL HEFLIN

Thank you Mr. Chairman. I applaud today's choice of topics. The issue of credit availability for small businesses is both timely and critical to our Nation's economy. As President Clinton stated in his state of the union address, "the real engine of economic growth in this country is the private sector." If the key component of the private sector, the small businesses, cannot get any fuel to run their engine then the Nation as a whole will suffer.

One reason this issue is so timely is that it coincides with the effort being made to rework our economic structure. I believe President Clinton has taken bold steps to honestly address the deficit issue. As we all know that issue so directly influences the issue we are here to discuss today. I am glad that the President has taken these initial courageous actions, and I hope this Committee can compliment his plan by working on fueling our Nation's small businesses.

If there is anything we can do in Washington to help increase the financial support for the small business people who drive our country's economic machine, we should be about doing it.

I applaud the Chairman for holding this hearing and I thank the distinguished witnesses for their willingness to come and testify.

Senator HEFLIN. In regards to the deficit, from the viewpoint of the Federal Reserve System and the economy, do you have a feeling that there ought to be, at least in the next year, 2 years, 3 years and 4 years, some type of a percentage reduction in the deficit that would really have some meaningful effect? If you look at it, do you have any specifics as to how much the deficit ought to be reduced on an annual basis?

Mr. MULLINS. First, Senator Heflin, I think we and many of my colleagues if not all of my colleagues, would agree with you that the deficit is a major problem. It has a corrosive effect upon the economic growth potential of this country.

We have seen the long-term bond rate drop from over 8 percent last April to below 6¾ percent today, and that is because the markets were so concerned about the future deficit that it was raising the cost of financing to businesses, hurting investment, hurting productivity growth.

One way to think of it is our deficit today soaks up 60 percent of our private domestic saving, and that just leaves too little of the saving available to fuel economic growth.

The CHAIRMAN. Would you repeat that, David? You do not have to change it. I just did not get it all.

Mr. MULLINS. Our deficit today, in a typical year, soaks up over half of our private domestic saving in the economy. So if you think of all the saving out there to fuel new investment and new growth, half of it goes into this deficit. That reduces the funds available and that is what has forced the interest rates up. That is why getting the deficit down will help increase the funds available out there for private industry and growth.

One way to measure it—not that I would come up with specific measures—is, again, to try to reduce the deficit so it is a much smaller fraction of private domestic saving so it does not take up 50 percent or 60 percent as it now does and generates more saving to be used for investment on the outside. The other typical way to calibrate it is to look at the deficit as a percentage of GDP, gross domestic product, and moving down toward the 2 percent range most people would believe would be very beneficial.

If you look at the countries that have typically been very successful in the world—Japan and Germany, people have talked about in recent years—there are a lot of differences in the way they run their economies. And there are all these people who study the micro-differences in the economies. What we notice is that, traditionally, while they have been growing so rapidly, they have had low deficits and they have had low inflation.

That is why we believe that one of the factors underlying the slow growth in productivity and income all during the 1980s was this growing deficit. And moving the deficit down more toward the level of 2 percent of GDP and the down to a much smaller fraction of our private domestic saving we believe is necessary to increase growth.

Senator HEFLIN. Thank you.

The CHAIRMAN. If I may, Mr. Chairman, just point out, what are we now? Between 5 percent and 6 percent of GDP?

Mr. MULLINS. Yes, sir.

The CHAIRMAN. Is Germany not in about the same situation we are in right now?

Mr. MULLINS. Yes. It is interesting. They have gotten themselves into a situation which looks a bit like us in the 1980s when we received some criticism for our situation. To finance reunification they have created large budget deficits. They have also created off-balance sheet financing arrangements——

The CHAIRMAN. Not totally unknown to us.

Senator HEFLIN. Well, they seem to be keeping the interest rates exceptionally high. Are they attracting all the available money that floats?

Mr. MULLINS. Well, this is what happens. When you have a large deficit, it is too expansionary. So you have to keep the interest rates high partially to finance that, as we did during the 1980s, and this puts pressure on interest rates and hurts the growth of the economy. So the deficits tend to give too much thrust to lending and economic activity and the result is that monetary policy ends up being very tight.

It is ironic to look at the policy, which is the one we suffered under for a long period of time, and we are now in the process potentially of reversing. We have the lowest short-term interest rates since 1963. There is the reduction in long-term rates—these are the lowest 30-year bond rates we have ever had because we have only been issuing them since 1977. And the ten-year rate is probably down this morning to 5.8 percent or something, and my guess is that would be about as low as 1968 or 1969. And if you think about the economic growth we got in the early sixties with those sorts of interest rates and low inflation and low deficits, then that is the potential payoff we have for cleaning up some of these problems.

Senator LIEBERMAN. Thank you, Senator Heflin.

Senator Kerry.

STATEMENT OF JOHN F. KERRY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator KERRY. First of all, thank you very much for holding this hearing. I have listened to all the questions since I have been here. I missed some but the Chairman informs me that you discussed a little bit about the securitization issue and I want to ask a few things about that.

What concerns me a little bit, Mr. Mullins—and you folks at the Fed are not directly responsible for this but you certainly are part of the chain. What concerns me is that, it is all well and good for us to sit here and there is a certain amount of high-faluting conversation about the steps that might be taken with respect to credit. But as the chairman of this hearing knows, New England has continued to suffer in very real ways on a day-to-day basis with a growing frustration level.

We are going to hear later in the third panel from Mr. George Burnell, who is president of the Icon Corporation of Woburn, MA, and he is really one story among just hundreds of stories of individual companies that are not just statistics representing the problems with the credit crunch. These are companies that are going under, companies that are losing jobs, companies losing business, companies that are struggling at a time when all of the drag on our economy is critical.

We heard Alan Greenspan before the Banking Committee a few weeks ago and he acknowledged that there is a credit crunch. Dick Syron and the Fed Reserve up in Boston have come out with a study that shows that while we are down about $30 billion in lending in the region, a good 10 percent, $3 billion or so, is directly credit crunch-related. Now, I am not sure it is not larger than that.

For the Icon Corporation, there are dozens of other stories. I can tell you about a metal fabricator company that I visited recently where the president of the company is living with his kids in the factory, lost his house and had to turn back business to Duke University because he could not get the line of credit and get worked out with recall management in time to be able to do it. I could give you instances of an electronics manufacturer, an ex-banker, who moved his company from Taiwan back to Massachusetts and they capped his credit because he is growing too fast because the bank, under the regulatory regimen, cannot make those loans.

We have had meetings. We had Nick Brady up to Boston 2 years ago and we sat there and told him these stories. We have had hearings in the Banking Committee as well as other Committees here, and it just seems to go on. Nothing seems to change.

[The prepared statement of Senator Kerry follows:]

PREPARED STATEMENT OF HON. JOHN F. KERRY

Mr. Chairman, I think this a very important hearing.

Over the past 2 years, I have been telling banking regulators that there is a credit crunch, and they have been telling us that it isn't true.

Finally, last month, Federal Reserve Chairman Alan Greenspan finally acknowledged that we were right, and that small businesses through no fault of their own were being squeezed to the wall by the credit crunch.

What we have seen at regional level in New England is a sequence of contraction in which intensified capital requirements have been put into place at same time as banks are experiencing losses due to the recession and the real estate collapse.

While some of the decrease in lending is due to reduced demand, we have numerous accounts of small businesses losing their ability to maintain commercial and industrial revolving lines of credit.

These have been often drawn down as a consequence of a "collateral crunch" resulting from the lowered value of the underlying real estate securing the lending, together with the desire of many of the banks to increase their capital ratios by reducing their outstanding business lending generally.

Later in this hearing we will hear from George Burnell, the President and CEO of Icon Corportation of Woburn, MA. Mr. Burnell described the tremendous damage to his business caused by his loss of credit because he happened to be unlucky enough to have chosen the Bank of New England as his lender. When Bank of New England went belly-up, the FDIC owned Icon's lines of credit, and began to squeeze them. The bank which purchased the assets of the Bank of New England was not interested in small business lending. The result was business contraction and job losses, as Mr. Burnell will testify.

Unfortunately, his case is all too typical.

What we have found is that small business borrowers who have weathered the recession and built up their order backlogs often cannot find new banking relationships. For these borrowers, the "collateral crunch" caused by deflated real estate and the imposition of tighter lending rules by both regulators and bankers have resulted in widespread complaints across my State that credit is still unavailable.

I can provide you with examples of all sorts: the metal fabricator I visited in the act of giving back business to Duke University because he could not finance it, and abandoning plans to rehire workers in the process; the president of a leading environmental technology firm who returned from a Mexican trade mission with Governor William Weld only to find that his bank had cut his line of credit despite increased orders; the exbanker who moved his electronic instruments manufacturing from Taiwan to Massachusetts only to find his bank capping his credit line because he is growing too fast to stay within applicable loan ratios. These unfortunately are not isolated cases, but representative of a pervasive problem.

Laura Tyson has testified in the Banking Committee here that she is attracted to approaches that stimulate lending through credit enhancement and securitization of small business lending. Today, I am introducing legislation designed to fight the credit crunch by creating a GSE, called VELDA SUE, to package and securities markets with small businesses.

Velda Sue would be similar in many respects to Fannie Mae, Freddie Mac, and Sallie Mae in its function and its mechanisms, and would be a government-spon-

sored enterprise that is not backed by the full faith and credit of the United States, but instead, has enhanced credit by being able to draw on a limited line of government credit.

The Federal Government would sponsor Velda Sue with initial loans of up to $300 million, after Velda Sue had raised $30 million in private funds. These U.S. Government loans would be repaid to the Treasury by Velda Sue in 15 years or less, with interest. Once established, Velda Sue would function with no cost to the Treasury. In additional, Velda Sue would under certain circumstances have the ability to call on the Treasury for additional short-term purchases of its obligations up to $1.5 billion, as a means of creating credit-enchancement through the limited backing of the Treasury. In turn, the Treasury would according to mutually agreed upon terms sell these obligations back to Velda Sue, plus interest, with no net cost to the government.

In the near term, Velda Sue could have a substantial impact in combating the credit crunch on small business lending, by creating a secondary market for such loans accessible to pension funds and insurance companies and other major institutional investors, making long-term capital available to finance purchases of plants and equipment.

Banks would continue to originate the small business loans eligible for securitization by Velda Sue, as would S&Ls, commercial finance companies, insurance companies, small business lending companies, and other loan origination businesses. In order to meet Velda Sue's underwriting standards, each loan would have to be secured by a non-subordinated mortgage, and be made to an enterprise which qualifies as a small business under the Small Business Act—one that does not have a net worth in excess of $18 million or an average net income in excess of $6 million. Velda Sue would not securitize the entire loan, only 80 percent, leaving the other 20 percent with the originating institution, insuring that the originator shares in any risk of default.

Velda Sue would be self-financing, with its operations paid through fees imposed on originators and poolers, with the Secretary of the Treasury given regulatory responsibility over its activities, and a board of directors consisting of a mix of private citizens appointed by share-holders and government appointees.

I want to emphasize that the way this legislation is structured, any funds that come from the government are repaid with interest, and the taxpayers wind up being on the hook for not a single penny.

I recognize that some of the specific mechanisms and details of the plan I am introducing today, which was developed by Congressman LaFalce, may change during the course of the legislative process. We need to take a careful look at a broad range of approaches.

I think we are agreed that early action is needed to create a vibrant secondary market in small business industrial mortgages.

I look forward to working with the Chairman in this area, and hope that some of the witnesses today will be in a position to offer their thoughts about Velda Sue and a small business GSE.

Senator KERRY. I must say to you I am reaching the point of exasperation. I do not understand it. The Senator from Illinois was with us 2 months ago when we had a hearing in the Banking Committee and the same issues were discussed.

Why is it so difficult to get the message and to change some of the basics here, either the leverage ratios or the risk capital process or the appraisal process for small loans? What is so difficult?

Mr. MULLINS. Senator Kerry, I would agree with you that it has been a long and difficult period, especially in New England. And I do think we are on the threshold of some significant progress here with the work with the new Administration. I might add that the Federal Reserve tends to favor phasing out the leverage ratio when we can.

In terms of why we have not had much effect yet, when we had the growth in debt in the 1980s and it was unsustainably high and we went into this adjustment period, the banks were absorbed with these bad losses, and the examiners were absorbed with these bad

loans and losses. And the force of that adjustment was such that many of these institutions were fighting for their financial lives.

As you will recall, over the past several years we have had a number of meetings with examiners and clarified our rules. I think that was an environment in which it was very difficult to get that message across, it was very difficult to make changes that stick because the pressure of the situation was simply so severe at that time.

Since that time, the economic part of it is much improved. Even in New England the banks are much improved. And the economy is starting to pick up, even in New England. But the loans have yet to flow. This is what makes us think that now is the time, with this improved climate, that we can have an impact. And I would agree with you. I think we have identified a number of these issues for a number of years and we ought to simply get it done.

Senator KERRY. I appreciate your saying that. I hope the statement will become the father to the fact.

Finally, if I could just mention, I am today introducing a companion bill to John LaFalce's bill in the House, which bears the horrible acronym of VELDA SUE, and we all regret that but that is what we are living with. But I think the concept is a sound concept. I believe you commented on it a little earlier. I hope colleagues will look at this. It is an effort to securitize, much in the way we do with Fannie Mae, Sallie Mae, Freddie Mac and so forth, for small business loans in the truest sense of small business loans under the definitions we operate with, and to help get credit out into the marketplace.

I know the Bank of Boston recently had a small business loan program it put together. It received some 7000 phone calls within a matter of months and put out 1200 new loans as a consequence, new people doing business. This is a beginning. But it is evidence of this pent-up demand which we need to respond to.

I hope that you and others will help us to move this forward as a way of greatly enhancing the availability of credit to small business in the short term. I hope colleagues will join in this effort. It will not cost the Government money. It is a way of rapidly providing that credit. Laura Tyson has talked positively about it, and I think you in your comments have mentioned that securitization offers some strong possibilities.

Senator CHAFEE. Well, Mr. Chairman, I would just say that I hope members of the Banking Committee will take a look at page 17 of the next witness' testimony to see the paperwork burdens that have been laden, presumably passed by the Banking Committee, on small business in the past 5 years. So a lot of the blame rests right here in the Congress of the United States. Every one of these things I am sure is splendid, but the cumulative effect of it, as testified to by Mr. Brandon, is horrendous.

Senator KERRY. I do not think there is any question. I think all of us are cognizant of an increased paperwork burden, and there are ways to deal with that. I would share with the Senator a desire to see us try to eliminate a certain amount of paperwork.

Obviously, there is a balance between CRA enforcement and legitimate information-gathering and that which becomes a burden,

but I think there is an excessive burden. I do not disagree with that. But I mean simple things.

What I am trying to talk about right now are simple things like the appraisal. You look at what has happened to a lot of these banks. If you have to jump through the same hoops for a $50 million loan as you do for a $250,000 loan—and, obviously, the profit margin is so much narrower on the smaller loan—there is an incentive, literally, in the banking structure now not to make those loans. I have talked to countless bankers across our state and small business people who have run into that buzz saw.

Mr. MULLINS. Many medium-size and larger institutions do not look at loans under $1 million because of the paperwork burden, which tends to be a fixed cost. We found in our survey in 1989, the average small business loan is $25,000 and the upper 90th percentile is $300,000 to $500,000. We have dramatically raised the fixed costs on those loans.

Senator KERRY. My time is up. But what confounds me is the fact that you do not have to be a bank analyst, a member of the Federal Reserve or a genius to know that it is not small business failures that brought these banks down. Yet small business have become the most significant victims of this new process.

You can look in New England or elsewhere in this country, and there is not a bank that failed as a consequence of abuses within small business lending. It is a tragedy, just beyond some capacity to describe, when you look at the reality of people living in their own factories and their kids dislocated out of homes and business lost and the number of jobs that have been lost as a consequence because bureaucrats and legislators have not been able to get their act together.

Senator LIEBERMAN. Thank you, Senator Kerry.

Senator Moseley-Braun.

STATEMENT OF HON. CAROL MOSELEY-BRAUN, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. Mr. Chairman, I have a written statement which I will submit for the record but I will synopsize and just ask a couple of questions.

We are all obviously concerned about the credit crunch, and I think that every hearing, every indication from Illinois indicates that it is a real one. We all want to get money in the form of cash and access to credit back into communities, to small businesses, so that we can create jobs.

However, the statistics that we have heard seem to suggest a conundrum. On the one hand, we have the problem of over-regulation and the excess costs that are associated with it and the chilling effect on lending activity, if you will, that the regulations are said to have, and I believe the bankers when they say that this is a problem. We have all this paperwork.

On the other hand, however, we have statistics and studies that show us that there really is—and to the extent there is a credit crunch—a credit vise, if you will, for women and for minorities and for urban areas when it comes to lending activity. We saw in the Committee, for example, with regard to real estate loans specifical-

ly, that blacks and other minorities were 60 percent less likely to receive a loan.

Similar kinds of statistics follow activity in terms of commercial lending. Women-owned businesses have similar difficulties. Urban areas, generally. That, of course, then inhibits the access to capital and credit in those areas where job creation, as a part of the national interest, is of such paramount concern.

The consumer groups are concerned about the issue of redlining, and we have heard a lot of testimony in Banking about redlining and the effect and what that does to kill communities and kill people's hopes and dreams of their ability to be able to realize the American dream and to become entrepreneurs.

That suggests, then, that the whole nouveau conversation about character lending may raise some problems in and of itself. It may give us old-boy network kind of lending practices again, which would lend more subjectivity instead of objectivity into the lending decision, and that would be counter-productive, I believe, and will not effect the result that I think all of us want to see.

[The prepared statement of Senator Moseley-Braun follows:]

Prepared Statement of Hon. Carol Moseley-Braun

Mr. Chairman, thank you for holding this hearing on the very important issue of the small business credit crunch.

There are almost 20 million small businesses in the United States. These small businesses are instrumental to the economic growth and vitality of this country. The Small Business Administration estimates that, between 1988 and 1990 alone, businesses with less than 20 employees created more than four million new jobs. It is estimated that 80 to 85 percent of the new jobs created in this country are created by small businesses. Yet, these businesses, which are so critical to America's economic performance face a threat that could dampen prospects for a long-term recovery and job creation—lack of available capital.

Statisticians and economists may argue whether there is a credit crunch and, if there is, why. From the viewpoint of businesses in Illinois especially small businesses, the issue is not in doubt. Small businesses in Illinois know that there is a credit crunch and they are suffering because of it.

The Small Business Administration section 7 (a) program, which guarantees up to 90 percent of a loan from a bank or other lender to a small business, has seen a dramatic increase in the number of applications for assistance, up 37 percent from last year. Because of the demand, the section 7 (a) program has already run out of funds for this quarter and has received approval to use its third-quarter and all fourth-quarter allotted funds. Its FY 1993 appropriation of $195 million, which gives it a total of $3.6 billion in lending authority, will not be enough to meet demand. The administration has asked for a FY 1993 supplemental appropriation of $141 million generating another $2.6 billion in loan authority.

To be eligible for the program, a business must show evidence that credit is not available. Doesn't the demand for this program tell us something? Obviously, small businesses are having problems getting hold of the necessary capital to grow.

My constituents need results so they can open new businesses, expand existing businesses, and create jobs. They are interested in what causes the credit crunch, but only insofar as that knowledge helps them develop a solution to the problem.

Several financial and regulatory factors will be examined today. While an overly rigorous regulatory environment may be causing some problems, we need to make sure that equal opportunity lending is observed.

Frankly, I believe our banking system is not as healthy as it should be. While last year was a record year for bank profits, it was preceded by years and years of poor earnings. An institution that is not healthy is not going to make a substantial number of loans regardless of the soundness of the business proposals.

I would like to see an environment created in which our banks can be healthy and competitive—and thus make more loans to small businesses. I hope some of the witnesses here today can offer us some advice in this area. I look forward to hearing their testimony.

Senator MOSELEY-BRAUN.I guess my questions are threefold.

One, what can be done to assure objectivity in the decisionmaking area while, at the same time, reducing the paperwork burden? Second, would a combination or more coordination of the examiner function; that is to say, the different regulations that have to be enforced,—would some kind of combination getting us down to, if you will, one form or close to it, one examination, one audit, would that assist in relieving some of the regulatory burden but, at the same time, requiring the kind of protections and safeguards and objectivity that I think have to be a part of the process?

Then finally, what suggestions would you have for us today to improve the regulators' accountability to consumers and to the financial institutions that they regulate?

Mr. MULLINS. Well, those are a lot of tough questions, Senator Moseley-Braun. I would say that we, of course, at the Federal Reserve, are committed to equal credit opportunity, and it is true that the flow of credit will determine the economic progress of communities. And I think it is apparent we have had problems in the past, and our study in Boston was one indication of that.

Senator MOSELEY-BRAUN. By the way, Mr. Mullins, someone in the audience said, "60 percent?" And that comes out of your study in Boston.

Mr. MULLINS. I do think we need to be able to reduce the documentation and still make sure that we meet the laws and our responsibility in this area, and we think there are ways to do it. Much of the documentation I have talked about here today has been on the safety and soundness side. Much of it we think is redundant. And I also think, though, in terms of ensuring equal credit opportunity, we can do a lot to reduce the documentation.

I would not see the reduced documentation as—we have to be careful that it is not an open door to discrimination, so you will still need to document compliance with the laws. But we still think there is a substantial amount of benefit which can be achieved through that reduced documentation.

Senator MOSELEY-BRAUN. That is also almost a universally held point of view. Everybody wants to see a leaner, meaner regulatory activity, and would like to see the documentation reduced in such a way that it is not onerous but still achieves the functions for which it was intended—assuring safety and soundness, assuring lack of discrimination.

Do you see any way that the kinds of audits—and they are different audits—that those audits can be brought together so that a bank, for example, or a lending institution does not have to suffer, if you will, six different sets of regulators coming in looking at the same books for different kinds of questions?

Mr. MULLINS. That is one we are trying to look at. This duplication of examinations has become a major problem.

One of my colleagues was at one of these hearings, and a banker from a small bank in the Midwest, a $14 million bank, who has seven employees said he had nine examiners in the other day and he did not have enough chairs.

I think this is one of the things we are looking at because we have had a large increase in the redundancy of the examination process, and bankers now spend an enormous amount of time on it.

I do not know if we fully count their opportunity cost in these figures that we quote on the cost of regulation; and it is just not clear to me, certainly on the safety and soundness side, why a well-capitalized institution, a very highly rated institution that has not had problems or, when they have had problems, worked their way out of it, why we need this regulatory overkill.

I also think, on compliance with the equal credit opportunity laws, we need better, more streamlined ways to do that. I think we ought to re-think our approach. I think the banks are going to require us to do this because the current approach does require a lot of burdensome documentation. And I think the consumer groups are going to do that as well, and I view that as a healthy discipline and part of our task here.

Senator MOSELEY-BRAUN. If I may, Mr. Chairman, the last question was suggestions you have to improve accountability in this area. Would you be prepared to, perhaps as a follow-up to this line of questioning, give us some read on where you are in terms of formulating proposals for increasing the accountability in this area? I do not see a contradiction between having a sound bank and having CRA requirements met, but if it means nine sets of regulators then, clearly, that gets in the way of doing either.

Mr. MULLINS. Yes. And, in fact, the objective of CRA was not supposed to be inconsistent with making profitable loans. These are communities which are not well served and we have a lot of evidence of that, and you should not be required to lose money on investing in communities.

And I will be happy to go back and see what we can pull together on our ideas on what we might do to improve accountability.

[Requested proposals for improved accountability follow:]

During the March 4, 1993 hearings, Senator Moseley-Braun raised a number of issues with Vice Chairman Mullins related to the need to continue our efforts to emphasize fair lending examinations while we increase the availability of small business credit, particularly with respect to so-called "character" loans.

We plan to do both. In discussing discrimination in small business lending, it is important to note the heightened attention in the past year to discrimination in home mortgage lending. The nature of the debate no longer is whether there is disparate treatment of minority applicants for home mortgages, but rather how the enforcement of fair lending laws can be strengthened. Two events in 1992 changed the debate. One was a study by the Boston Federal Reserve Bank and the other was a settlement between the Department of Justice and an Atlanta savings and loan association resulting from a fair lending investigation by the Department. In both cases, the conclusion was reached that there was disparate treatment in mortgage lending when comparing minority and white applicants.

During recent months in 1993, much concern has been expressed over the lack of small business lending and its effect on the economy. In March 1993, the four federal regulators of banks and thrifts [1] released two joint statements about their initiatives to address these concerns (see the attached statements). According to the March 10, 1993 statement which introduced the agencies' program, these initiatives are "part of a broader effort to ensure equal credit opportunity for all Americans and to make credit and other financial services available to low- and moderate-income neighborhoods and disadvantaged rural areas." Thus, the initiatives of the regulators, including those to improve small business lending (see March 30, 1993, statement), are being undertaken, hand-in-hand, with focused attention to fair lending laws. The agencies are currently working on detailed projects to carry out the March 10 Statement.

---

[1] The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision.

Having recognized the importance of fair lending in small business credit, it must be said, however, that discrimination is not easy to detect. The Boston Federal Reserve Bank study on mortgage lending began its inquiry using data that the Congress has required financial institutions to collect for home mortgages such as the race, sex, and national origin of applicants. Similar data, however, is not required and, in fact, is prohibited to be collected for other forms of credit, including for small business loans.

As a result of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), two initiatives are underway to collect information on small business lending. Beginning in June 1993, and continuing annually thereafter, insured depository institutions will report as part of their "reports of condition" (call report) data on business and farm loans by size of loan. In addition, FDICIA requires the Federal Reserve to collect and publish, on an annual basis, information on the availability of credit to small businesses, including, to the extent practicable, minority small businesses. An initial report was submitted to Congress in December 1992. To enhance future reports and our understanding of small business credit, the Federal Reserve has initiated a substantial survey of small businesses that will focus on financing and credit use by such firms.

To strengthen enforcement of fair lending laws, the federal regulators are taking several steps to increase discrimination awareness on the part of both bankers and examiners. In March 1992, the agencies distributed to the institutions they supervise a brochure, prepared by the Federal Financial Institutions Examination Council (FFIEC) agencies, entitled "Home Mortgage Lending and Equal Treatment" (copy attached). The brochure identifies and cautions lenders about lending standards and practices that may produce unintended discrimination. Although the brochure is about home mortgage lending, much of its information can be applied to lending in general. In December 1992, the FFIEC contracted with an outside consultant to review the agencies' examination procedures to enforce civil rights laws. The consultant will also review existing training processes and recommend improvements. In addition, the FFIEC agencies continue to pursue discussions with the Department of Justice, the Department of Housing and Urban Development, and the Federal Trade Commission to strengthen their enforcement of civil rights laws.

At the Federal Reserve, the program for fair lending enforcement involves consumer compliance examinations, consumer complaint investigations, and community affairs efforts. The consumer compliance examinations are conducted by examiners at the Reserve Banks who are specially trained in consumer affairs and civil rights examination techniques. A regular part of these examinations includes conversations with persons in the community knowledgeable about local credit needs and about public perceptions of the availability of credit to minorities and low- and moderate-income persons. The consumer complaint investigations arise out of a program at the Board and each of the Reserve Banks to deal with consumer complaints. Under the appropriate circumstances, consumer complaints will prompt an on-site investigation by the Reserve Bank at a state member bank accused of discrimination. The Community Affairs program at the Federal Reserve helps to advance fair lending through its outreach, education, and technical assistance activities.

To strengthen its fair lending enforcement, new initiatives are underway at the Federal Reserve. The Board has authorized its Division of Consumer and Community Affairs to hire an individual whose primary job responsibility will be to work in the area of fair lending enforcement. This person will help to coordinate efforts in this area and assist examiners in analyzing the complex issues associated with detection of credit discrimination. To review fair lending practices in mortgage lending, the Federal Reserve, in consultation with the other FFIEC agencies, has developed a system that increases our ability to analyze data required by the Home Mortgage Disclosure Act (HMDA). Among other things, the system enables examiners to select specific loan files for review during onsite fair lending examinations. The Federal Reserve is also developing the capability to map the geographic location of a bank's lending products, including HMDA data. This mapping will include demographic information for the bank's local community. The Federal Reserve believes that this type of analysis and presentation will enhance its ability to assess a bank's Community Reinvestment Act (CRA) performance in meeting the credit needs of its local community, including minority areas. It should also be helpful in evaluating a bank's geographic delineation of its local CRA service area to ensure that it does not exclude low- and moderate-income neighborhoods.

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Credit Availability

March 10, 1993

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — today announced a program directed at dealing with problems of credit availability, especially for small and medium-sized businesses.

The program will focus on the five areas in which the agencies will take action designed to alleviate the apparent reluctance by banks and thrifts to lend. Those areas are:

- Lending to Small- and Medium-sized Businesses
- Real Estate Lending and Appraisals
- Appeals of Examination Decisions and Complaint Handling
- Examination Processes and Procedures
- Paperwork and Regulatory Burden.

The agencies intend to complete virtually all of the changes proposed in the program within the next few months. As the specifics of any change are finalized, that change will be made and published while details of other changes are in the process of being finalized.

A complete statement about the actions the agencies have planned is attached. The statement reaffirms the agencies' belief that it is in the interest of lenders, borrowers and the general public that creditworthy borrowers have access to credit.

This policy statement will be distributed to all federally examined banks and thrifts and to all regulatory agency offices and examiners.

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Credit Availability

March 10, 1993

Problems with the availability of credit over the last few years have been especially significant for small- and medium-sized businesses and farms. This reluctance to lend may be attributed to many factors, including general trends in the economy; a desire by both borrowing and lending institutions to improve their balance sheets; the adoption of more rigorous underwriting standards after the losses associated with some laxities in the 1980s; the relative attractiveness of other types of investments; the impact of higher capital requirements, supervisory policies, and examination practices; and the increase in regulation mandated by recent legislation — specifically, the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — recognize that in the last several years the buildup of certain regulations and practices has become overly burdensome. Indeed, those regulations and practices may have, in some cases, stifled lending, particularly to small- and medium-sized businesses that met prudent underwriting standards.

It is in the interest of lenders, borrowers, and the general public that creditworthy loans be made. Since economic growth, especially job growth, is fueled primarily by small- and medium-sized businesses, credit availability to those borrowers is especially important. Accordingly, the agencies are working on the details of a new program to help ensure that regulatory policies and practices do not needlessly stand in the way of lending. Loans to creditworthy borrowers should be made whenever possible, as long as they are fully consistent with safe and sound banking practices.

Background

The new program is one aspect of an overall effort by the agencies to evaluate carefully and react appropriately to risk in the United States financial services industry. That overall effort envisions substantial oversight, in some cases more than we have now, in areas that pose greater risk to the system. By the same token, regulatory burden will be reduced where risk is low, especially for strong, well-managed banks and thrifts. This program is also part of a broader effort to ensure equal credit opportunity for all Americans and to make credit and other financial services available to low- and moderate-income neighborhoods and disadvantaged rural areas.

The Program

The new program involves a variety of regulatory and other administrative changes which have been agreed to in principle by the agencies. These changes fall into five categories, each of which is discussed below.

Timing. The agencies will work to complete virtually all of the changes outlined below within the next three months. Once the specifics of any of the changes are agreed upon, that change will be made and published, while distribution of other changes remains to be made.

1. Eliminating Impediments to Loans to Small- and Medium-Sized Businesses

Reducing Documentation. Strong and well-managed banks and thrifts will be permitted to make and carry a basket of loans with minimal documentation requirements, consistent with applicable law. To ensure that these loans are made to small- and medium-sized businesses, there will be a ceiling on the size of such loans and limits on the aggregate of such loans a bank may make.

Encouraging Use of Judgment\Borrower's Reputation. The agencies will issue guidance to make it clear that banks and thrifts are encouraged to make loans to small- and medium-sized businesses, particularly loans in the basket discussed above, and to use their judgment in broadly assessing the creditworthy nature of the borrower -- general reputation and good character as well as financial condition may be elements in making these judgments. Reliance on a broad range of factors when making a credit determination is especially important.

Other Assets Especially Mentioned. Improper use of the category of Other Assets Especially Mentioned (OAEM) may inhibit lending to small- and medium-sized businesses. Accordingly, the agencies will clarify that examination and rating procedures do not group OAEM loans with classified loans.

2. Reducing Appraisal Burden and Improving the Climate for Real Estate

The experience of the last decade has underscored the importance of sound underwriting standards and effective supervision for commercial real estate loans. Nonetheless, in certain instances regulatory burdens may be adversely affecting loans to sound borrowers. This may be particularly so in the case of loans secured by real estate that are primarily used for non-real estate business purposes. Real estate collateral is often pledged for loans to small- and medium-sized companies that have few other tangible assets.

Using Real Estate Appraisals Prudently. In some cases currently required real estate appraisals may not add to the safety and soundness of the credit decision. Indeed, in some cases, appraisals may prove so expensive that they make a sound small- or medium-sized business loan uneconomical. Accordingly, the agencies will make changes to their rules relating to real estate appraisals along the following lines:

- **Accept Additional Collateral**
  When real estate is offered as additional collateral for a business loan, both the time and expense involved in obtaining an appraisal from a certified or licensed real estate appraiser may discourage a bank or thrift from taking the collateral, may increase the cost of credit significantly, or even may cause the loan not to be made. In some such cases, the real estate appraisal requirement is counterproductive from a safety and soundness perspective. Moreover, the constraint on credit flows to sound businesses may be substantial. Accordingly, the agencies will alter their real estate appraisal rules so as not to require an appraisal by a licensed or certified appraiser for such loans.

- **Reexamine Appraisal Thresholds**
  Appraisals conducted by licensed and certified real estate appraisers, even on real estate of modest value can be quite costly. In the case of a smaller loan, the requirement of an appraisal by a licensed or certified real estate appraiser may make a sound loan uneconomical. Accordingly, the agencies will reexamine their existing rules to make certain that thresholds below which formal appraisals are not needed are reasonable.

- **Limit Periodic Appraisals**
  In some cases real estate appraisals have been required after a loan has been made, and in circumstances where the appraisal did not add to the safety and soundness of the loan. Accordingly, the agencies will work to make certain that real estate appraisals are required after a loan is made only when clearly needed for safety and soundness purposes, provided of course, that all requirements under law have been met.

Changing Rules on Financing of Other Real Estate Owned. Currently, accounting and other rules may discourage banks and thrifts from providing financing to borrowers who wish to purchase real estate classified as Other Real Estate Owned. The agencies will review rules relating to the reporting treatment and classification of such loans and make appropriate changes to facilitate financing to creditworthy borrowers, consistent with safe and sound banking and accounting practices.

Reviewing In Substance Foreclosure Rules. The inappropriate use of in substance foreclosure rules have required foreclosure valuation treatment of loans when borrowers were current on principal and interest payments and could reasonably be expected to repay the loan in a timely fashion. The agencies will work with the appropriate authorities to alter that treatment and to coordinate a change in accounting principles and reporting standards.

Avoiding Liquidation Values on Real Estate Loans. Loans secured by real estate should be evaluated based on the borrower's ability to pay over time, rather than a presumption of immediate liquidation. The agencies will work with their examination staffs to ensure that real estate loans are evaluated in accordance with agency policy.

3. Enhancing and Streamlining Appeals and Complaint Processes

Appeals. It is important for bankers to have an avenue by which they can obtain a review of an examiner's decision when they wish. For that reason, each of the agencies has established an appeals process. To ensure the effectiveness of those processes, each agency will take appropriate steps to ensure that its appeals process is fair and effective.

In particular, each agency will ensure that its process provides a fair and speedy review of examination complaints and that there is no retribution against either the bank or the examiner as the result of an appeal.

Complaints. Each of the agencies has a process to handle more general complaints from the institutions they regulate and from the general public. Although the volume of such complaints can be high, each agency recognizes that reviewing and responding to these complaints is an important element of proper supervision. The agencies are particularly concerned that complaints of discriminatory lending practices be handled with the utmost seriousness and on an expedited basis.

Accordingly, the agencies will review their complaint processes to improve both the care with which complaints are scrutinized and the timeliness of responses.

4. **Improving Examination Process and Procedures**

Reducing the Burden of the Examination Process. A proper examination of a bank or thrift by its very nature involves some disruption to the examined institution. Such disruptions, however, are costly to the institution and can interfere with its credit functions. It is highly desirable that examination disruptions be minimized.

Accordingly, the agencies have agreed to intensify efforts to minimize such disruptions and, in particular, to take the following steps: (i) eliminate duplication in examinations by multiple agencies, unless clearly required by law, (ii) increase coordination of examinations among the agencies when duplication is required, and (iii) establish procedures to centralize and streamline examination in multibank organizations.

Refocusing the Examination Process. If examinations are to fulfill their functions in the areas of safety and soundness, fair lending, and consumer protection compliance, it is important constantly to reexamine the elements of the examination to determine whether the process is effective. Similarly, regulations and interpretations must continually be assessed to determine whether they are fulfilling these functions.

To improve the regulatory process, the agencies have agreed to heighten their emphasis in examinations on risk to the institution and to issues involving fair lending in place of areas that have become less productive over time. Agency policies and procedures will be reviewed with this focus in mind.

Reducing Regulatory Uncertainty. Uncertainty is part of the regulatory burden that banks and thrifts face and that contributes to their reluctance to make some credits available. This uncertainty can stem from ambiguous language in regulations and interpretations, from delays in publishing regulations and interpretations, and from failures to follow uniform examination standards that clearly reflect agency policies.

Accordingly, the agencies will review their regulations and interpretations to minimize ambiguity wherever possible and will step up efforts to publish regulations and interpretations required by law or sound regulatory practice. In addition, the agencies will reemphasize to their examiners to follow agency policies and guidelines carefully and accurately in carrying out examinations and reviewing applications. The agencies will make every effort to ensure that examination and application processing is performed uniformly across the country.

5. **Continuing Further Efforts and Reducing Burden**

Further Efforts. Additional items will be reviewed for possible change. One item that will be reviewed relates to the treatment of partially charged-off loans. Under current practice delinquent loans that have been partially charged off cannot be returned to

performing status even when the borrower is able to, and fully intends to, pay the remaining interest and principal to the bank in a timely fashion. The agencies will work to develop common standards for determining when a loan may be returned to accrual status.

Paperwork Burden. No good is served by forcing banks to bear an excessive regulatory paperwork burden. Accordingly, the agencies have begun and will continue to review *all* paperwork requirements to eliminate duplication and other excesses that do not contribute substantially to safety and soundness.

Regulatory Burden. It is not paperwork alone that unnecessarily burdens banks and thrifts. Regulations and interpretations also may be unnecessarily burdensome. In some cases the passage of time has made regulations outmoded. In other cases the regulations may not have fulfilled their goals.

Accordingly, the agencies also have begun and will continue to review *all* regulations and interpretations to minimize burden while maintaining safety and soundness standards.

Joint Release	Office of the Comptroller of the Currency Federal Deposit Insurance Corporation Federal Reserve Board Office of Thrift Supervision

Interagency Policy Statement on Documentation of Loans

March 30, 1993

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — today announced further details on the implementation of their March 10 program to increase credit availability. Today's policy statement outlines changes in the area of loan documentation.

The strongest banks and thrifts, those with regulatory ratings of 1 or 2 and with adequate capital, will now be able to make and carry some loans to small- and medium-sized businesses and farms with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital. Eligible banks and thrifts will be encouraged to make these based on their own best judgment as to the creditworthiness of the loans and the necessary documentation. These loans will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation.

Each minimal documentation loan is subject to a maximum loan size of $900,000 or 3 percent of the lending institution's total capital, whichever is less. If a borrower has multiple loans in the exempt portion of the portfolio, those loans must be aggregated before the maximum is applied. Loans to institution insiders — executive officers, directors, and principal shareholders — are ineligible for inclusion, as are loans that are already delinquent.

The package also offers some relief for banks that do not qualify for the program, and for loans that are not in the exempt portion of a bank's portfolio. The policy statement also includes guidelines which provide institutions some additional flexibility in applying their documentation policies for small- and medium-sized business and farm loans without examiner criticism.

Today's initiatives are directed at eliminating unnecessary documentation and reducing costs to lending institutions and the time it takes to respond to credit applications. OTS will soon issue a regulation to amend its current loan documentation requirements to comply with the statement. For banks, the program requires no change in existing regulations and is effective with today's release.

The complete program is being mailed to all regulated institutions and all examiners, and additional copies are available from the agencies.

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms

March 30, 1993

Introduction

Problems with the availability of credit over the last few years have been especially significant in the area of small- and medium-sized business and farm lending. This reluctance to lend may be attributed to many factors, including general trends in the economy; a desire by both borrowing and lending institutions to improve their balance sheets; the adoption of more rigorous underwriting standards after the losses associated with some laxities in the 1980s; the relative attractiveness of other types of investments; the impact of higher capital requirements, supervisory policies, and examination practices; and the increase in regulation mandated by recent legislation — specifically, the Financial Institutions Reform, Recovery, and Enforcement Act and the Federal Deposit Insurance Corporation Improvement Act.

The four federal banking agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — expect small- and medium-sized business and farm loans, like all credits, to be made consistent with sound underwriting policies and loan administration procedures. The agencies are concerned, however, that institutions may perceive that the agencies are requiring a level of documentation to support sound small- and medium-sized business and farm loans that is in excess of what is necessary to making a sound credit decision. Unnecessary documentation raises the cost of lending to small- and medium-sized businesses and farms, results in delays in bank lending decisions, and may discourage good borrowers from applying. The agencies believe that the elimination of unnecessary documentation for loans to small- and medium-sized businesses and farms will reduce costs to the institution and the time it takes to respond to credit applications from small- and medium-sized businesses and farms without adversely affecting the institution's safety and soundness.

The federal banking agencies expect financial institutions to maintain documentation standards that are consistent with prudent banking policies. However, the maintenance of documentation beyond that necessary for a credit officer to make a sound credit decision and to justify that decision to the institution's management adds to loan administration costs without improving the credit quality of the institution. Unnecessary documentation impedes the institution from

responding in a timely and prudent manner to the legitimate credit needs of small- and medium-sized businesses and farms in its community. Accordingly, the agencies are taking steps to correct any misunderstanding of regulatory requirements and to reduce regulatory impediments to lending to creditworthy small- and medium-sized businesses and farms.

Documentation Exemption for Small- and Medium-sized Business and Farm Loans

Well- or adequately capitalized institutions with a satisfactory supervisory rating will be permitted to identify a portion of their portfolio of small- and medium-sized business and farm loans that will be evaluated solely on performance and will be exempt from examiner criticism of documentation. While bank and thrift management will retain responsibility for the credit quality assessment and loan loss allowance for these loans, the lending institution will not be subject to criticism for the documentation of these loans.

This exemption will be available only to institutions that are well- or adequately capitalized institutions under each agency's regulations implementing section 38 of the Federal Deposit Insurance Act and that are rated CAMEL or MACRO 1 or 2. These institutions are by definition those that have demonstrated sound judgment and good underwriting skills; moreover, their strong capital position insulates the deposit insurance funds from potential losses that may be incurred through small- and medium-sized business and farm lending.

To qualify for the exemption, each loan may not exceed the lesser of $900,000 or three percent of the institution's total capital, and the aggregate value of the loans may not exceed 20 percent of its total capital. In addition, loans selected for this exemption by an institution must not be delinquent as of the selection date, and each institution must comply with applicable lending limits and other laws and regulations in making these loans. Furthermore, such loans may not be made to an insider.

Small- and medium-sized business and farm loans that do not meet the criteria for exemption set forth in this policy statement would continue to be reviewed and classified in accordance with the agencies' existing policies.

The details of the exemption are as follows:

- **Documentation exemption.** Each institution eligible for the exemption provided in this policy statement may assign eligible loans, subject to the aggregate limit on such eligible loans, to an exempt portion of the portfolio. Loans assigned to this exempt portion will not be reviewed for the completeness of their documentation during the examination of the institution. Assignments of loans to the exempt portion shall be made in writing, and an aggregate list or accounting segregation of the assigned loans shall be maintained, including the performance status of each loan.

- Restrictions on loans in the exempted portion of the portfolio. The institution must fully evaluate the collectibility of these loans in determining the adequacy of its allowance for loan and lease losses (ALLL) or general valuation allowance (GVA) attributable to such loans and include this evaluation in its internal records of its assessment of the adequacy of its ALLL or GVA. Once a loan in the exempt portion of the portfolio becomes more than 60 days past due, the loan may be reviewed and classified by an examiner; however, any decision to classify would be based on credit quality and not on the level of documentation.

- Eligible institutions. An institution is eligible for the documentation exemption if (1) pursuant to the regulations adopted by the appropriate federal banking agency under section 38 of the FDI Act, the institution qualifies as well- or adequately capitalized, and (2) during its most recent report of examination, the institution was assigned a composite CAMEL or MACRO rating of 1 or 2.

- Ineligible loans. Loans to any executive officer, director, or principal shareholder of the institution, or any related interest of that person, may not be included in the basket of loans.

- Aggregate limit on loans. The aggregate value of all loans assigned to the basket of loans provided for in the exemption may not exceed 20 percent of the institution's total capital (as defined in the capital adequacy standards of the appropriate agency).

- Limit on value of individual loan. A loan, or group of loans to one borrower, assigned to the basket of loans provided for in the exemption may not exceed $900,000 or 3 percent of the institution's total capital (as defined in the capital adequacy standards of the appropriate agency), whichever is the smaller amount.

- Transition from eligibility to ineligibility. An institution that has properly assigned loans to the exempt portion of its portfolio pursuant to this statement but subsequently fails to qualify as an eligible institution may not add new loans (including renewals) to this category.

Treatment of Small- and Medium-sized Business and Farm Loans Not Qualifying for Exemption

The agencies will continue current examination practices with regard to documentation of small- and medium-sized business and farm loans at institutions not qualifying for the exemption and loans at qualifying institutions that are not assigned to the exempt basket. The guiding principle of agency review will continue to be that each insured depository institution should maintain documentation that provides its management with the ability to:

(a) make an informed lending decision and to assess risk as necessary on an ongoing basis;

(b) identify the purpose of the loan and the source of repayment;

(c) assess the ability of the borrower to repay the indebtedness in a timely manner;

(d) ensure that a claim against the borrower is legally enforceable; and

(e) demonstrate appropriate administration and monitoring of a loan.

In prescribing the documentation necessary to support a loan, an institution's policies should take into account the size and complexity of the loan, legal requirements, and the needs of management and other relevant parties (such as loan guarantors).

In applying these standards, the agencies will continue to recognize the difficulty and cost of obtaining some documents from small- and medium-sized businesses and farms. These difficulties and costs could result in some deviations from an institution's own loan documentation policy for small- and medium-sized business and farm lending. Such deviations are frequently based on past experience with the customer. In such cases, the loan will not be criticized if the examiner concurs that sufficient information exists to serve as a basis for an informed credit decision.

Implementation

This policy statement will take effect immediately upon issuance. However, the agencies will monitor how qualifying institutions implement its provisions and how those institutions and the loans they designate for inclusion in the exempt basket perform. Changes to this policy statement may be made based on the agencies' experience.

Senator MOSELEY-BRAUN. Thank you very much.

Senator LIEBERMAN. Thank you, Senator Moseley-Braun.

Mr. Mullins, your testimony has really been very helpful, your analysis helpful. I appreciate the interest in possible creation of a secondary market for small business loans.

I want to echo what Senator Kerry said, and perhaps we do it with a little more intensity from New England because our region seems to continue to suffer. We see the banks doing better, which is good news. But we do not see the loans occurring to the small businesses, and that makes it harder for us to come out of the recession.

I also particularly welcome the initiative that the President and Chairman Greenspan and yourself have made about regulatory review. And because of the sense of urgency here, I want to suggest something that seems unlikely and perhaps a little radical, which is that, when you come up with your conclusions you will still have to go through the normal process for changing regulations, which will take a long time. And there is a real sense of urgency about it. Witness the fact that the President has come in with approximately $16 billion of short-term stimulus funding.

I wonder whether we might, after we look at your recommendations for regulatory changes, think about either finding some extraordinary way to cut down the regulatory change process, or actually turning it into legislation. It stretches the imagination to think that Congress could actually act faster than anyone else, but in this case, because of the mood here, it is possible that we might, by legislation, actually be able to move more quickly as part of a stimulus package to change some of these regulations on banking.

Mr. MULLINS. I think it is an idea I will take back to the working group on how we might expedite implementation of our proposals, because there is a long lag typically in changes in regulation.

Senator LIEBERMAN. Thank you very much.

The CHAIRMAN. David, you have been an excellent witness. Your candor and your common sense and your professional knowledge of these things is really refreshing to this Committee.

Senator CHAFEE. Mr. Chairman, could I just make one point very briefly?

One of the problems is that when decisions are made in Washington, DC in the regulatory area, they are either so vague or lack specificity that the examiners in the field offices do not get the word, or, if they get the word, it is confused. And so I would implore you to make your directives very precise and unambiguous so that the regulated banks out there in Providence or Pawtucket, Rhode Island will understand them. That has been one of the problems in our state.

Mr. MULLINS. I would agree, Senator Chafee. And again, one of our objectives here and one of our focuses here has been on implementation, because much of the work over the past couple of years in clarifying standards has not had much of an impact on the front line. So we are giving a lot of thought about ways to make sure that it changes behavior out there and not just makes a good press release back here.

Senator CHAFEE. Thank you.

Senator LIEBERMAN. Again, Mr. Mullins, thank you very much. We are lucky to have you at the Fed.

I will call the second panel now. Mr. Bill Brandon, President of the American Bankers Association and President and CEO of The First National Bank of Phillips County, Helena, AR; and Mr. James Lauffer, President-Elect of the Independent Bankers Association of America and Chairman, President and CEO of The First National Bank of Herminie, Irwin, PA.

Mr. Brandon, Mr. Lauffer, thanks very much for being here. Do you want to add anything to this welcome, Mr. Chairman?

The Chairman. Nothing, except to say this may be the more important president Arkansas has produced. He has been respected in banking communities in our state for many, many years and been a very dear friend of mine for 22 years, and it is an honor to be Chairman of this Committee and have him testifying in his capacity. Bill, I have read your statement, which I think is a dynamite statement.

Senator LIEBERMAN. Mr. Brandon, welcome.

STATEMENT OF WILLIAM H. BRANDON, PRESIDENT, AMERICAN BANKERS ASSOCIATION

Mr. BRANDON. Senator Bumpers, you mentioned that you would not go on my bank board. I have to say that, now, we pick bank board members because they possess extraordinary business acumen, knowledge, judgment. If you agreed to go on the board, I would assume you had none of those.

[Laughter.]

The CHAIRMAN. I am going to appraiser's school.

Mr. BRANDON. I am sorry the Senator from Minnesota had to leave. He said he was going to hold special hearings on small towns, small business. I have an observation that is personal, it is not an ABA observation, it is mine.

I think what you will find in the next 5 years is that 1000, at least 1000, small town banks will be gone if regulation and the attitude and the atmosphere that we have today prevails through that time. But I will not get into that. That is another subject.

What I would like to do is emphasize that there is not one thing that we can do that will cure 100 percent what is wrong. It would be more like 100 things that could cure one percent of what was wrong, and we would have to work it back that way.

For my testimony, rather than do it formally, what I would like to do is run through some loan cases and show how these laws affect it and show how the regulations affect it. Senator Moseley-Braun made a statement about CRA and she made a statement that she is concerned that different things will affect CRA lending and the other type lending that bothered her. And I agree with her.

The first loan I want to talk about is to two people; they happen to be minority in this case, and they happen to be low income. Came up with a great idea, just a great idea, and it was to start a daycare center for elderly people. And in my area, there are hundreds of people whose parents or grandparents need care and they

cannot afford that care. So they were going to start a daycare center for them.

We would love to have made that loan. We feel like that is a good loan, we feel like that loan would be repaid. The need is there, everything about it is there. But we cannot make it. It would be a law violation to make that loan because the amount of money that goes into that loan, the type of loan that is, is working capital primarily.

So they agreed to put up their homes. They both agreed, both couples agreed to put their homes up. Unfortunately, the value of those homes is not enough to allow us to meet the guidelines that are directed down by FDICIA. The net of that is, if we make that loan, we would be instantly in violation and we would be instantly written up, and there is nothing the examiners could do about that. We certainly cannot make it open. It is much too large a risk open. With the collateral there of the real estate it would be an acceptable risk to us. We could have made that loan, but we cannot make that loan. That is one of the things that is happening.

Another example is, we had in our bank a home in our other real estate, and somebody really got innovative and said, I tell you what let's do. Let us find us a young couple, both working, that do not have any down payment but have a chance of making a success in the future, and let us make them a 100 percent loan on that house and let us require them to agree to put some sweat equity in it as they go along.

I cannot make that loan today. I could have made it 5 years ago, but today I am in a law violation. So that is another loan that cannot be made.

Senator CHAFEE. What is the rule violation there?

Mr. BRANDON. The rule violation is that the guidelines say you cannot exceed 80 percent on real estate, and I would be 100 percent on real estate so I am in violation. And it is a law and I would have to be written up for that, and you cannot afford to be written up. Many times there are consequences, bad consequences, to having too many violations.

Another one is a small bank in Florida, an excellent bank, they make a lot of money. They have made a lot of money for a long time. They run their bank well, they have extremely high capital, probably double what it would take to be well-capitalized. They have plenty of loan reserves, they have a good board. The board got together and made a loan to a company that they had been loaning to for over 5 years. This year, the loan request was a little higher, the risk was a little higher, but it was still a good loan. Nobody had a concern about it. They had the exit interview with the examiners. The examiners so frightened that board that they called a special board meeting the next morning and rescinded that loan.

Now, why did they do that? They were concerned about civil money penalties, they were concerned about agreements. Even though that is a perfectly good bank, it shows the power that you have got when you go in to someone and say, "You can be fined up to a million dollars a day if you make a mistake." And that is what it comes down to—do not make a mistake. You wonder why that board wants to go in government bonds? They are afraid of making a mistake.

Let us take another case, a character loan. We talk about character loans. Here is a young man who is 17, had a paper route, and the first thing we did was lend him money to get him a little car to do his paper route. The next thing we did is we gave him a student loan to go to school. The next thing we did—he went to work, he got him a little business on the side that worked out.

Then he comes to us under today's environment and he has a much bigger loan and he is talking about $50,000. He wants to buy a truck and he has got a really good idea to work it out where a company that is burning refuse can sell it somewhere else and he will truck it down, come back, truck it down. Perfectly good loan. The problem, is if we take that truck as collateral, even if he pays 20 percent down on that truck, we know, we absolutely know, that if we ever had to take it back, when we got it back it would not be worth but 50 cents on the dollar. History will show you that. So we are under-collateralized.

Now, what would we normally do? We would make that loan. What did we do in this case? We turned it down. We turned it down because the examiners now, under their rules,—and certain parts of FDICIA say that they want you to set guidelines to measure banks by. Under their rules, we would have to have a secondary source of repayment, which he does not have in this particular case, and we would have to have 3 years' worth of financials, which we do not have in this particular case because he has not been in business 3 years. We should make that loan.

There is good news to this story. The loan officer would not accept "no." It took 4 months, but on the fourth month that he presented that loan again and again and again, we finally decided we ought to make that loan. We made it.

The point of the story is, though, one time out of five it will be made. The other four, it will not be made because it is going to go on your books as a sub-standard loan because it did not have those things.

These kind of stories go on and on and on. Senator Bumpers, I can tell you one where we made a loan and we made an appraisal on it ourselves. The property was sold, we got our money back, our appraisal was correct. Now, the property is up for sale again and we cannot make a loan—and there are 50 jobs involved—because we cannot find anybody to appraise it because you cannot get comparables. And it is so litigious out there now that the appraiser is saying, "If I do not get the comparables and you want to come back and sue me because it does not bring what I said it would bring, I am subject to being sued." So he says, "I simply will not do it." We cannot find an appraiser. If I cannot find an appraiser I cannot make the loan, and the 50 jobs are gone. Maybe we will find an appraiser; we are still looking. There is no exception left out there.

My point to you is this. I think we need to find a way. The point was made earlier that small business loans are not breaking these banks. We talked about that in our loan committee just before I came up here, and the amount of money we have lost through the years on small business loans has been so small that the bank can handle them without even blinking. The same thing on small real estate loans. We just do not lose money on those. That is not where your problem is.

But what we have done is, we have gotten to the point we feel we have to micro-manage out of Washington to the point we cannot make any exceptions, and there is no judgment left. And the banking industry,—if you will look at your own constituents, size them up. "I think they're honest, I think they're hard-working." Maybe not every single person in the world is, but most. Let us work together to find a way to back off of some of the things that do not hurt safety and soundness. I am for safety and soundness just like you are. And I thank you.

[The prepared statement of Mr. Brandon follows:]

PREPARED STATEMENT HON. WILLIAM H. BRANDON, JR.

Mr. Chairman, I am William Brandon, President and CEO of the First National Bank of Phillips County, Helena, AR, and President of the American Bankers Association. The American Bankers Association is the national trade and professional association for America's commercial banks, from the smallest to the largest. ABA members represent about 90 percent of the industry's total assets. Approximately 94 percent of our members are community banks with assets of less than $500 million.

I am delighted to be here today to talk with you about banks, small businesses and the economy, and I congratulate you for calling this hearing to discuss these critical issues. We all know that a healthy small business sector is vital to a growing economy. Small businesses employ about 60 percent of the private work force in this country and, in recent years, have accounted for virtually all of the economy's net job growth—with most of the new jobs being created by firms with fewer than 20 employees. Small businesses produce about 40 percent of our gross national product and 50 percent of the total output of the private sector. In other words, small businesses are not small potatoes to the economy.

Mr. Chairman, you asked me to discuss the impact of credit availability—or more precisely, the lack of credit availability—on small businesses. The linkage is simple—without access to credit, small businesses cannot grow and prosper. And for most small businesses, bank loans are a very important source of credit. This brings me to the first issue I would like to discuss with the Committee this morning—what has happened to credit growth in general, and bank lending in particular, in this recovery?

There is no doubt that the growth of credit following this recession is quite different than it was following past recessions. In fact, total credit extended to non-financial firms has grown only four percent since the start of the recession in 1990 -- a much lower rate of growth than was the case in any recession in the last three decades.

Figure 1

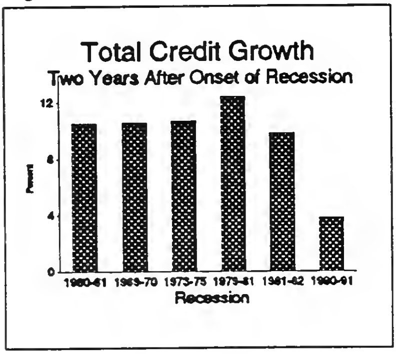
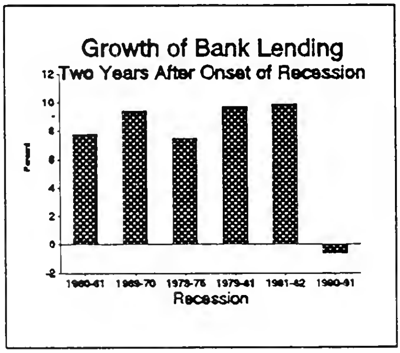


Figure 2



A more important difference between this recovery and previous recoveries is that the growth of bank lending has been *negative* since the beginning of the 1990-91 recession. In fact, the difference between the rate of growth of bank lending during this recovery and the average rate of growth exhibited during past recoveries is nearly *ten* percent. This represents a contraction of *over $200 billion* annually compared to what might have been achieved if bank credit had expanded at the average rate.

The Impact On Small Businesses

It is no surprise that the impact of reduced credit availability hits hardest on small businesses. A recent survey by Arthur Andersen and National Small Business United found that new businesses got more than a quarter of their start-up funding from direct bank loans; indirectly, home equity loans provide another important source of start-up funds for new businesses. Banks are also the single most important source of the short-

Banks are in the business of lending—that is what banks do. So why is the behavior of bank credit in this recovery so different from previous recoveries?

There are a lot of reasons. Certainly, the recession and the weak recovery have led to decreased loan demand and have made banks more cautious lenders. But there is something else going on here that we need to understand, and that is the impact of the oppressive regulatory environment on bank lending. I believe that its effect on credit availability and economic growth is substantial. The ability of banks like mine to lend to the small businesses in towns like Helena is slowly but surely being undermined by layer after layer of regulation and red tape.

There are two dimensions to this problem that directly affect the credit en'nronment for small businesses. First, excessive paperwork and red tape are driving up the cost of running a bank and therefore the cost of bank credit. And second, regulatory micro-management has reached the point where it seems that virtually every loan decision I make is second-guessed—in essence, the examiner's judgment is being substituted for the judgment of my loan committee. What does this mean for my community and for communities across the country? It means more expensive credit and less of it.

THE COST OF BANK REGULATION AND CREDIT AVAILABILITY

No one regulation can be singled out as being the problem. This makes it tough to get your arms around the problem—and even tougher to solve it. But when you look at the layer after layer of new regulations heaped on banks, it isn't hard to understand what I'm talking about when I say "excessive regulation." Over the past 6 years, more than 40 major provisions affecting bank operations have been passed, resulting in hundreds and hundreds of pages of new regulations. (See attached list of new laws.)

Let me just quickly touch on the cost of these regulations. Our estimate of the annual cost of compliance is about $10 billion. A recent study by the bank regulatory agencies said the cost could be as high as $17 billion. Whatever the right number is, it is big—and most important, it is getting bigger. (See attached summary of ABA's survey of the cost of regulation).

Filling out endless forms and documenting our every move costs real money money that is no longer available to support loans. It also makes my bank—and all banks—less competitive by constantly ratcheting up our cost structure. Providers without these costs are going to find it easier and easier to attract away my customers. While I am busy documenting my community lending activities, preparing written policies, and spending weeks with regulators, my non-bank competitors like Merrill Lynch are busy selling financial products to my customers. And while my employees are filling out CTRs, trying to explain federally mandated funds availability schedules, and generally trying not to run afoul of the maze of compliance paperwork that covers virtually everything we do, they have less and less time to spend giving personal service to our customers.

Mr. Chairman, I figure that if I lose only 25 percent of my customers to these lower cost providers, I'm out of business. And I would guess that at least 25 percent of my customers are sufficiently cost sensitive that they will move their business if they can iind good service at a lower cost. This does not bode well for the future of the banking business.

Obviously, this is a big problem' for bankers. But why should this Committee care? The answer is simple—because small businesses need banks. Large corporations can go directly to money and capital markets to raise funds. Even consumers have other sources for home mortgage loans, credit cards, and auto loans. But for small businesses, bank financing is critical. Let me emphasize, Mr. Chairman, that the firms to which I am losing business—securities firms, insurance companies, mutual funds—do not make the type of small business loans I make. Nor do they have the stake in the community that I have. If banks like mine are forced out of business, who will lend to the small businesses in towns like Helena?

THE NEGATIVE LENDING ENVIRONMENT AND CREDIT AVAILABILITY

The second point I would like to make this morning deals with the impact of regulation on the lending environment. This may seem like a subtle point, but in my opinion it is having a tremendous impact on bank credit availability.

The clear message to bankers and their boards of directors—epitomized by some provisions in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) is "make no mistakes in lending." Mr. Chairman, there is no such thing as risk-free lending. And if bank portfolios must have virtually no risk, small business lending will come to a screeching halt.

The impact of the negative lending environment has not gone unnoticed by the Administration. President Clinton has urged the regulators to take a more balanced approach to bank regulation, and the heads of the regulatory agencies themselves have stated publicly that overzealous examinations have unnecessarily contributed to a lack of credit availability.

As this testimony was being prepared, press stories indicated that President Clinton would soon be announcing an administrative program to improve the regulatory process to help make more credit available, particularly for small businesses. While we have not seen the details of this program, we are optimistic that it will be an important step in restoring balance to the regulatory process.

Unfortunately, there are limits to what the Administration can accomplish through this approach. By raising these questions, I certainly don't want to lessen the importance of what the President may announce, but rather I want to be realistic. There are two limiting factors. First, even on the regulatory side, we must be concerned about the ability to implement the proposed changes. The Bush Administration tried to take certain actions to restore balance, but found it very difficult to convince examiners, those who implement the policies, to fully carry out the changes. Bank regulation is a subtle process, and the interpretations of the individual examiner are critical. However, in the same week that President Clinton was telling a joint session of Congress about the need to restore balance to bank regulation, GAO head Charles Bowsher was telling the House Banking Committee that even tougher bank exams were needed.

Mr. Chairman, examiners in the field are very much influenced by these types of hearings and by the statements of the GAO, which has actively placed itself into the bank regulatory process. We are concerned that these types of hearings and the actions of the GAO will greatly undermine the President's proposal.

The second limiting factor is that there is only so much that can be accomplished through the regulatory process. That is why ABA strongly supports S. 265, the Economic Growth and Regulatory Paperwork Reduction Act of 1993. S. 265 would, if enacted, provide the needed changes in law to restore balance, without undermining safety and soundness. The bill would be a real help to small businesses by making more credit available and by lowering the costs of obtaining credit.

Let me give you a few quick examples of what I mean by a negative lending environment.

> Take so-called "character loans". These loans are very important to small businesses, and they are the type of loan banks have traditionally specialized in. But in the current environment, a banker's judgment of a borrower's likelihood of repayment is frequently ignored. Examiners often want to see a secondary source of repayment and at least 3 years of demonstrated business experience. Loans made without this type of documentation are very likely to be classified. What does this mean in the real world? Let me give you a personal example. We had a young man come to us for a loan. He had been a customer of our bank for 15 years, and had always paid back his loans on time. He had a good idea for a business, but he needed a loan to buy a truck to get started. We turned him down. Why? Because the loan would have been classified as soon as the examiner saw it. He had no secondary source of repayment, and no three years of businesses experience. This was a character loan—we knew him, and knew that he would pay us back. But in today's world, the examiners want to see something besides the truck and the man's character behind the loan.
>
> Mr. Chairman, this customer was persistant. He brought the loan proposal back to the bank four times over the course of 4 months. Finally, with some fear and trepidation, we decided to make the loan even though we know it will cause trouble at our next examination. So this story had a happy ending for the borrower. But for each loan like this that gets made despite the regulatory impediments, many, many more do not get made. My point is that the regulatory process is squeezing out this type of borrower by not letting me use my judgment about the creditworthiness of my customers.
>
> Another example of how regulation impacts lending: at a meeting last week, a Texas banker told me that his bank had just enough money to hire one more employee. He intended to hire another loan officer to generate more business for the bank—but when he looked at his work load, he concluded that he had to hire a $45,000 per year compliance officer to keep up with government red tape and paperwork instead. So much for new business development.
>
> Mr. Chairman, I know you are interested in encouraging very small loans to startup businesses. A banker from Texas told us this week that he thinks it now may cost $10,000 to process a small business loan, in large part because of regu-

latory costs. Obviously, this makes the really small business loan uneconomical, not just for banks, but for the small business person as well.

In some cases, regulatory red tape and huge potential penalties for technical violations make banks hesitant to offer certain products. For example, the paperwork involved in making variable rate loans mean that many banks just don't offer these products. My bank offers only a handful of variable rate loans because we are very hesitant to get too involved in such a complicated product because of the risk of making an inadvertent mistake. The end result? Many bank customers don't have access to these products. And in today's interest rate environment, borrowers with variable rate loans are clearly better off than those with fixed rate loans.

Added up across all banks, the negative lending environment has serious consequences for credit availability and economic growth. In fact, we may well have created a regulatory framework which has forced the banking industry to become too risk-averse for the good of the economy.

Let me add one final thought while we are talking about the impact of regulation on bank credit availability. It concerns an issue raised in your letter of invitation to testify today. The banking industry supports solid capital requirements. We recognize the need for banks to maintain a strong capital position, and I do not want my remarks here today to be interpreted as asking for weakened capital standards. However, it is important to understand that recent increases in bank capital requirements probably did affect the cost and availability of bank loans, particularly in those areas of the country hardest hit by the recession.

Five years ago, a bank was required to hold a 6 percent capital against a loan. The risk-based capital requirements, phased in over the past 4 years, raised the ante to 8 percent. FDICIA raised it once again to 10 percent for institutions that want, as most do, to qualify as well-capitalized. While some banks already met the ten percent requirement, some did not. During the phase-in of the increase, some banks were forced to achieve higher capital ratios by avoiding growth or even by shrinking. This was particularly true in the north-east and did cause credit availability problems.

Mr. Chairman, as you pointed out in your letter of invitation, there has been a lot of discussion lately about the fact that banks hold more in government securities than in commercial loans. During recessions, loan demand is weak and it is not unusual for banks to increase their holdings of securities, although every banker will tell you they would rather increase good loans than buy additional securities. It is likely that this shift away from lending toward securities was exaggerated in the recent recession by rising bank capital requirements and the switch to a risk-based capital standard. But I want to emphasize that the credit availability problem we face today is much broader than that, and the growing regulatory burden is a much more significant cause.

Also, it seems likely that most of the problems with the new capital requirements are now behind us. Because of potential importance, it would be useful to study how the structure of capital standards has affected the availability of bank credit, particularly to small businesses and consumers, and a provision of S. 265 requires such a study.

The bottom line is that with the increased regulatory burden, the micromanagement of loan decisions, and the pressure for ever higher capital levels, it is no wonder that banks across the country have been slow to expand their lending activities.

BANK SAFETY AND SOUNDNESS AND THE REGULATORY BURDEN

Let me now turn to two issues regarding bank safety and soundness. First, it is my belief that the way things stand now, the red-tape burden has grown so large that it is actually counterproductive to bank safety and soundness. Second, there are a great many ways to reduce the paperwork burden that would free up scarce resources for bank lending without affecting the integrity of the regulatory apparatus in place to protect the safery and soundness of the banking industry.

On the first point, let's look at three examples of how the current negative regulatory environment has adversely affected safety and soundness.

One example that is of particular importance to small businesses is the cost of appraisal requirements mandated by FIRREA. Many examiners are applying these standards to real estate collateral taken as an "abundance of caution"—that is, collateral that is not critical to the loan, but is used to strengthen the bank's security position. Applying FIRREA's extensive and costly appraisal requirements to property that is not the primary collateral substantially raises

the cost of the loan. The result? Either the borrower, frequently a small business, pays more for the loan; or the banker doesn't take the collateral, which puts the bank in a less secure position. That perverse result was certainly not what Congress intended when it adopted the appraisal requirements, and it certainly doesn't enhance bank safety and soundness.

Another example is the difficulty more and more banks are experiencing in attracting and retaining qualified board members. Increases in civil money penalties, personal liability, and heavy-handed restrictions on lending limits to directors are among recent legislative changes that have created an environment that makes it very unattractive to be a bank director.

Regulatory agencies, encouraged by some in Congress, are aggressively bringing suits against bank directors—even against directors who have discharged their duties responsibly. These individuals, by serving on a bank board, are putting their personal assets in jeopardy, and have no assurance that their defense costs can or will be reimbursed if they are sued. Even worse, Section 2521 of the Crime Bill gives FDIC the right pane to attach a director's assets which may deprive him of the ability to even retain counsel to defend himself. Only depository institution directors are subject to this draconian law.

It's no wonder that successful business people who possess the very talents banks need to remain profitable and competitive in a changing business climate are declining to serve on bank boards.

The growing complexity of bank regulation and the potential for huge monetary penalties for even inadvertent technical violations is also beginning to have an effect on the ability of banks to hire an outside counsel with banking experience. Because outside bank counsel may be considered as an "institution affiliated party" FDIC's jurisdiction may be extended to them, thus subjecting them to the whole panoply of enforcement tools that the FDIC may use against the bank and Bank officers. We are told that this potential liability means that attorneys whose business is more than ten percent banking related are facing increasing difficulty in getting professional liability insurance because insurers are worried about their exposure to loss. Unfortunately, this leaves banks either without outside counsel or with outside counsel that is likely to be less experienced in banking law and regulation.

Taken together, these problems are clearly counter-productive to the goal of promoting safe and sound banking.

On the second point, there are ways to reduce the paperwork burden—such as those embodied in the Economic Growth and Regulatory Paperwork Reduction Act of 1993 (S. 265)—that will improve the bank lending environment without compromising safety and soundness. As stated previously, the banking industry strongly supports S. 265. We believe that it goes a long way toward addressing our concerns with the current regulatory structure outlined above, and that its passage will enhance the ability of the industry to meet the credit needs of all our customers, including small businesses.

S. 265 will reduce the burden of unnecessary paperwork without affecting the regulators' authority to take all necessary actions to deal with unsafe and unsound practices. For example, regulators will continue to have the authority to remove bank management, terminate deposit insurance, restrict asset growth, force divestitures of subsidiaries, restrict transactions with affiliates, and restrict certain activities including the use of brokered funds. These, along with a whole host of other regulatory and supervisory tools, ensure that passage of S. 265 will pose no additional risk to the deposit insurance fund.

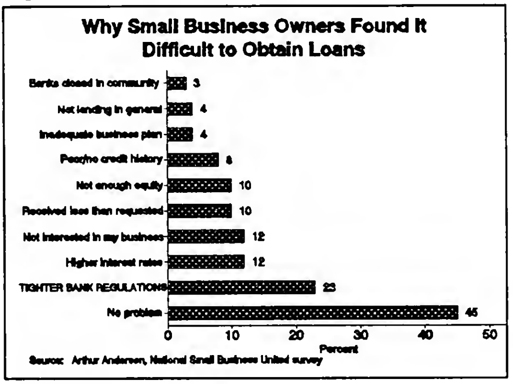
In fact, reducing the paperwork burden on banks will help protect the deposit insurance fund by enabling the banking industry to compete without the dead weight of excessive compliance costs; after all, only a competitive industry can hold and attract capital, which is the first line of protection for the insurance fund.

Other business groups, including the U.S. Chamber of Commerce, are also concerned about the problems caused by the avalanche of red tape that threatens to bury the banking industry. Pointing to what they called "the danger of capital starvation" for businesses, the Chamber joined ABA in our campaign to cut the red tape. The Chamber called for regulators to change the lending environment in order to allow banks to take prudent risks on business loans, including "character loans."

The National Association of Home Builders (NAHB) has also endorsed S. 265 because it will "help to reestablish a healthy credit environment." The housing industry has traditionally been instrumental in pushing the economy forward following a recession. But with the negative lending environment of the past few years, home builders -- especially small companies -- have been faced with tough times. Speaking in support of S. 265, NAHB's president said the bill would "help the banking system meet the credit needs of home builders and support overall economic recovery."

Many other business groups are indicating their support for legislative action to address this issue. To see why, look at this chart, which shows that excessive bank regulation is the number one cause of credit availability problems according to small business borrowers themselves.

Figure 3



Environmental Liability and Bankruptcy Reform

Mr. Chairman, there are two other important issues I would like to mention, both of which affect the availability of bank credit to small businesses. The first issue that deserves quick Congressional consideration is environmental liability. Current interpretations of the law have left lenders unclear regarding their liability for environmental clean-up of foreclosed property in cases where the lender had no responsibility for causing the environmental damage. The result is that many lenders are reluctant to lend on any property that may have environmental problems. This is particularly important for small business borrowers who often use real estate as collateral

for a loan. As you know, legislation to address this problem passed the Senate twice but stalled in the House, despite the fact that over half the Representatives were cosponsors.

The second issue is the need for bankruptcy reform. Abuse of the bankruptcy system is driving up the cost of credit and decreasing its availability. Legislation dealing with this issue passed both the House and Senate last year without one negative vote, but unfortunately, it died in the log-jam at the end of Congress.

Mr. Chairman, I understand that these initiatives are not under the direct purview of this Committee, but I urge you and your colleagues to lend your support to passing these important reforms.

BANK PARTICIPATION IN SMALL BUSINESS ADMINISTRATION PROGRAMS

Mr. Chairman, I would like to take a minute to discuss a Federal program over which this Committee does have jurisdiction—the Small Business Administration. As you are well aware, the banking industry is a major participant in various SBA programs. A primary example is the loan guarantee program, which is authorized by Section 7(a) of the Small Business Act of 1953. This program benefits the national economy and small communities through the jobs created and revenues produced by the small businesses that use the program.

The 7(a) program is uniquely suited to help banks meet the needs of undercapitalized small businesses. For example, a bank may use the program to help eligible small businesses purchase needed equipment, to relocate operations, and/or to provide working capital. Without the 7(a) program, these loans could not be made. The guarantee program is especially important to long-term debt financing. By permitting longer-term amortization of loan repayments, cash flow pressure on the borrower is14¶reduced, which contributes to business growth and job creation which would not happen without the guarantee programs.

Unfortunately, Mr. Chairman, SBA programs, particularly the 7(a) guarantee program, are victims of their own success. The demand for 7(a) guaranteed loans consistently outstrips the allocation of guarantee authority that Congress provides for these loans. Even with the additional $1 billion allocated to the program for this fiscal year, applications for assistance continue to hit log-jams waiting for quarterly funds to be released.

There is another problem that is discouraging the use of SBA and other federally guaranteed loan programs. This concerns the regulatory treatment of nonperforming guaranteed loans. If I have an SBA loan that becomes nonperforming, I have to count the whole loan amount as nonperforming—not just the unguaranteed portion. Why should the guaranteed portion be considered nonperforming if the government has guaranteed repayment? By putting the whole amount as nonperforming, it overstates the ratio of nonperforming loans to total loans and may trigger a more severe regulatory response than is appropriate. This treatment certainly does not increase my willingness to make these kinds of loans. Who suffers? Small businesses who rely on SBA loans and other federally guaranteed programs. This is clearly counter to the intent of these programs.

The Senate Small Business Committee's continued support for the SBA programs is certainly appreciated by the banking community. We know that your Committee will be looking at other initiatives in the small business area, and we would be pleased to work closely with you in designing and promoting increased availability of small business capital and credit.

CONCLUSION

Mr. Chairman, there is no doubt that the heavy hand of regulation is a major factor inhibiting banks' ability to fulfill their traditional role as lenders to small businesses. The current negative lending environment and the excessive costs of red tape have had a chilling effect on loans to the very people who are most likely to create new jobs. What is clearly needed is balance—bankers recognize the need for adequate safety and soundness regulation, but we must not be forced to become so risk-averse that we shut off financing to vital segments of our economy. Where would this country be if banks had never made character loans to finance small business and entrepreneurial ventures?

There is no magic bullet that will get credit flowing again. But we must begin the process of reducing the excessive paperwork burden on the banking industry and we must change the negative environment that permeates bank lending markets. We believe that the Economic Growth and Regulatory Paperwork Reduction Act (S. 265) is an important first step, and we urge the members of this Committee to support its passage.

We are pleased that President Clinton is undertaking regulatory initiatives to help restore balance to bank regulation and to begin to address the negative lending environment. But I would like to emphasize that it will take more than regulatory initiatives alone—it will take legislative action to clearly demonstrate that it is the intent of Congress that banks take prudent risk in lending.

Mr. Chairman, I thank you for this opportunity to share my views on these issues with your Committee. I would be pleased to answer any questions you may have.

Some Major Bank Regulatory Provisions Enacted in the Last Five Years

Supervisory Provisions:

(1) *Required prior approval for certain changes in bank officers and directors*

(2) *Subjects bank personnel to the loss of personal assets without adequate due process*

(3) *Required operational and managerial standards for bank operations*

(4) *Subjected banks to regulatorily-imposed performance standards*

(5) *Subjected banks to new rules on real estate lending*

(6) *Annual full-scale on-site examinations for all banks*

(7) *Annual required management reports/audits*

(8) *Increased civil penalties -- up to $1 million per day*

(9) *Complete overhaul of bank appraisal practices*

(10) *Liability on affiliated banks for loss/potential liability of bank holding companies*

(11) *Expanded regulatory authority to restrict bank operations*

(12) *Expanded authority to remove bank officers and directors*

(13) *Required public disclosure of enforcement actions*

(14) *Expanded the public disclosure requirements of FIRREA*

(15) *Increased regulatory authority to remove deposit insurance*

(16) *Increased penalties for faulty call reports*

(17) *Toughened civil and criminal forfeiture provisions*

(18) *Increased criminal sanctions for bank personnel*

(19) *Further increased criminal sanctions for bank personnel*

(20) *Created a private right of action against bank personnel*

(21) *Limited the retirement benefits of bank officers, directors and employees*

(22) *Requires regulatory standards on compensation of bank officers, directors and employees*

(23) *Created a new supervisory structure for undercapitalized banks*

(24) *Subjected banks to a risk-based insurance premium structure*

(25) *Subjected banks to regulations restricting interbank liabilities*

(26) *Imposed new restrictions on credit to bank and BHC personnel*

(27) *Supplemental disclosure of the fair market value of assets and liabilities in financial statements and reports*

(28) *Restricted state bank powers*

(29) *Placed limitations on bank funding mechanisms*

(30) *Revised capital standards to include interest rate risk and other factors*

(31) *Placed limitations on the use of purchased mortgage servicing rights (PMSRs)*

(32) *Subjected banks to "back-up" FDIC enforcement authority*

Consumer Provisions:

(33) *Passage of the Expedited Funds Availability Act*

(34) *Increased HMDA recordkeeping and disclosure*

(35) *Expanded credit card disclosures*

(36) *Increased disclosures on home equity loan products*

(37) *Increased disclosure of "small" business and "small" farm loan data*

(38) *Mandated disclosures on savings accounts*

(39) *Increased CRA burdens*

(40) *Increased servicing and escrow disclosure*

(41) *Required disclosure on changes in FDIC insurance coverage*

(42) *Expanded disclosure and recordkeeping on business loans*

(43) *Placed limitations on adjustable rate mortgages*

(44) *Mandated disclosure of branch closings*

THE ALARMING SIZE OF THE PAPERWORK BURDEN—SURVEY RESULTS

The American Bankers Association recently completed a survey of banks to find out just how much banks spend to comply with the maze of bank regulations. The findings, compiled from over 1,000 responses, are frightening. Consider the following:

Banks spend an estimated $10.7 billion on compliance each year. This does not include the very large new compliance costs related to FDICIA, the nearly $6 billion paid annually in deposit insurance premiums, nor the estimated $1.6 billion cost of sterile reserves held at the Fed. A recent study by bank regulators said the cost could now be as high as $17 billion.

The paperwork burden absorbs a disproportionately larger percentage of small banks' operating costs and profits. In fact, for banks with assets less than $50 million in assets, one out of every four dollars of operating dense il spent on compliance.

For large banks (with assets over $1 billion) the total compliance cost is well in excess of $5 billion annually.

Some 41,000 bank employees are dedicated, tull-time, to compliance ilsues. That's more than twice the capacity of Madison Square Garden.

Bank CEOs devote on average one full day per week to compliance issues—this amounts to almost 5 million CEO hours per year for the industry as a whole.

In small banks (under $50 million in assets), over 15 percent of staff time is devoted to compliance issues. Most of these banks have 25 or fewer employees.

The regulatory burden discourages some banks from offering certain products. For example, many of the survey respondents said that they do not offer adjustable rate mortgage loans, home equity lines of credit, other types of real estate-based loans, and variable rate consumer loans because of the difficulty and expense involved in providing the proper disclosures, not to mention the harsh penalties which may result from inadvertent technical errors.

Senator LIEBERMAN. Thank you very much, Mr. Brandon. I look forward to asking you some questions.

Mr. Lauffer?

STATEMENT OF JAMES LAUFFER, PRESIDENT-ELECT OF INDEPENDENT BANKERS ASSOCIATION OF AMERICA AND CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF FIRST NATIONAL BANK OF HERMINIE, IRWIN, PA

Mr. LAUFFER. Thank you, Mr. Chairman. I am encouraged by the things I have heard this morning. My name is Jim Lauffer. I am chairman, president and CEO of the First National Bank of Herminie in Irwin, PA, which is 23 miles east of downtown Pittsburgh, a $185 million bank with six offices. I have been with the same institution for 32 years, CEO for 22 years, and I would like to point out one thing.

Mr. Mullins mentioned that a lot of banks do not look at anything under $1 million, and I think that is the difference between community banks and big banks. We have made business loans, I have personally, for $500, up to $1 million.

I come before you today as president-elect of the Independent Bankers of America, which is the only trade association that exclusively represents community banks across the country.

There is a problem with small loans and you have heard a lot of the reasons here this morning. So I will not go through them point by point because a lot of them would be redundant. But we do have a credit crunch and there is a problem. It has been recognized by Chairman Greenspan who, just last week, said there is a problem of regulatory cost that is involved in this process which is inhibit-

ing small business loans. And the sentiment has been echoed by President Clinton, also.

Chairman Greenspan talked about character lending, and I agree with Bill. We could get examples, we could get hundreds of those same examples across the country where you cannot make character loans anymore, and that is what small business is really about. And community banks play a big, big part in lending to main street America and to the small businesses.

But FDICIA, in its fullness, has not been written yet. And if we go many more years with the type of regulation that have been piled on with FIRREA and FDICIA, I agree with Bill. We are going to have a lot, lot less community banks.

Mr. Chairman, the connection between regulatory burden and the credit crunch led to an effort by the five banking trade associations to send a letter to President Clinton outlining both regulatory and legislative changes that could be made that could create more small business lending. We were challenged by Chairman Greenspan to document how much it cost. When I say, "we," I am referring to the Independent Bankers of America. We got the accounting and consulting firm of Grant Thornton. They did a study for us on 13 pre-FDICIA regulations. Now, that is pre-FDICIA. The 13 of them come up to a cost of $3.2 billion. Extrapolating that over the entire banking industry, we come up to $11 billion annually. Community banks are spending 48 million hours annually complying with just 13 regulatory areas, and none of that had to do with FDICIA.

Mr. Mullins mentioned there are 60 working groups on FDICIA. Most of our member banks, the vast majority of them, do not have 60 people. So, as those 60 work groups developed the regulation and the statute and it comes to a bank with 10 employees, they do not have 60 different people to say, "All right. You learn what this one is, you learn what that one is, and you put it together so we are in compliance." So there is a big gap here between one size fits all. It just does not work, and that is what we have tried to do across the Nation.

We have presented to President Clinton corrective actions. They are in our written testimony. But we know that we need legislative action, too. I am not sure I agree with Mr. Mullins that 50 percent of it can be done by the regulatory people. They are subject to coming up here and talking. There is a strong sentiment in some of the banking committees that we need more regulation rather than less regulation. So we think we need some legislative action.

The 1989 savings and loan crisis just created all kind of havoc in this industry with FIRREA and then FDICIA, with Congress desiring the regulatory people to micro-manage the banks, and it is just not working.

The thing that is still to come is Section 132 of FDICIA, which is going to set Nationwide standards on a whole bunch of other procedures. That has not even been written in total yet. We have seen no writings to this date. But that particular section, 132, is going to standardize more things and take positions of judgment out of our hands even greater.

So we would ask that you look at some of these FDICIA sections that have not even been written and maybe delay them, maybe

hold off on them for a period of time. Because the point was well taken. All this regulation came at the same time as the economy going into a tailspin. And bankers have been reluctant to do anything, because if the law is not written, how do they know what to do? So all of this aggravated the whole thing.

Another proposal was the community development banks which President Clinton has proposed. We think the concept is a sound idea, but we think there are institutions in place. If given the right government incentives, tax breaks, CRA credits, training, some credit enhancement, the same thing can be done with institutions that are in place.

Another proposal rebates to creating a secondary market for small business loans through a government-sponsored enterprise. We have looked at that. The credit enhancement part, I think we have to be very careful of because we might drive these loans out of the banking industry. Plus, if you try to securitize small business loans of $500, $5000, $50,000, it is going to be very difficult to make them fit into one size fits all, as mortgages do in the secondary market.

Other legislative action unrelated to FDICIA would be helpful, also. In particular, we congratulate you, Mr. Chairman for your efforts in the Paperwork Reduction Act. We also support changes in the bankruptcy system. That has been a bad deal. Environmental lender liability. Gas stations, printing shops, cleaners—we do not even lend to them anymore because you do not know what the liability is going to be. If you make a $30,000 loan and may be liable for a $1 million loss, are you going to make that loan? So there need to be some changes in that area.

Community banks are under a tremendous regulatory burden. One other issue that is in my written testimony but not in my oral that I would like to address is interest rates. Interest rates in this country are the lowest in years, which we have heard, and everybody thinks that is a good thing. And it is a good thing for certain segments of the economy. But it is not a good thing for people on the CDs and people who are living on fixed incomes and are seeing their yields cut in half.

Now, the problem we are seeing, and USA Today reported about a month ago or two, is that 17 percent of the CDs in the country, in all the banks, did not renew this year. Thirteen percent in my own bank. Now, that is a new situation. CDs under $100,000 are our funds, our core deposits, to make loans. Now these 13 percent, we tracked them, and they went to the mutual funds and the annuities.

Now, the mutual funds and annuities do not have to conform to CRA. All the regulations we are under, they are free from. Plus, they do not make any local community loans.

So my suggestion is—we do not know if this money is ever going to come back to the banking industry. Once the economy picks up and we look at our core deposits,—and they are now down 13 percent, 17 percent—we may not have the money at that point to keep feeding the loans. So I think it is a concern that this Committee and others in Congress should be considering, because this money is being sucked out of communities where you make small business loans into mutual funds and into the annuity market.

I appreciate the opportunity to testify and stand ready to answer any questions that you might have.

[The prepared statement of Mr. Lauffer follows:]

PREPARED STATEMENT OF HON. JAMES LAUFFER

Mr. Chairman, my name is James Lauffer and I am Chairman/President/CEO of The First National Bank of Herminie in Irwin, PA. I am serving as President-elect of the Independent Bankers Association of America (IBAA). The IBAA is the only national trade association that exclusively represents the interests of community banks.

We appreciate this opportunity to testify before the Senate Small Business Committee about credit availability to the small business community. I can tell you today, Mr. Chairman, that each of our members not only count small businesses among their best customers, but count themselves as part of the small business community. We are locally owned and operated, and unless we provide the small businesses of our communities with the credit they need, neither they nor our member banks will prosper and create the jobs that fuel our economy.

Small business loans are not being made to the extent needed to sustain the economy, however. The credit crunch which has enveloped the Nation for so many months continues, albeit more so in some regions of the country than in others. While there are some signs that the economy is beginning to recover, it is a recovery that has failed to create sufficient jobs.

In his recent Humphrey-Hawkins report to the Senate Banking Committee, Federal Reserve Board Chairman Alan Greenspan was asked if the credit crunch was real. He responded that indeed, it is real, and went on to cite several factors contributing to the credit crunch, including the cost of regulatory pressures resulting from recent legislation. And just last week before a House Banking subcommittee he said that "[T]here is a problem of regulatory cost that is involved in this process, which is inhibiting small business loans." This sentiment was echoed on the same day by President Clinton in a speech before the U.S. Chamber of Commerce, where he said that he wants "to try to make it possible for banks to loan money to businesses again, to try to release the energies for the old-fashioned character small business loans."

Chairman Creenspan, in discussing the need for regulatory relief last week, noted that character, or judgment, lending, which has historically been a significant part of small business lending, is being regulated out of the banking system. These loans may not meet the strictest paperwork requirements taught in examiner school, but they have been the staple of bank lending and local economic development for years. Examiners insist that small business loans meet homogeneous standards. That is driving these loans out of our banks.

According to Chairman Greenspan, documentation requirements for these loans have made them prohibitively costly for community banks. "What we have done by removing the character loans is we have removed the economic franchise of the small bank who had very strong competitive advantage over the larger banks, and those from other areas, who didn't know the people in the particular community...what we are doing is undercutting our small community banks by essentially taking their franchise away from them..." He said that reviving the ability to make character loans would play a key role in easing the credit crunch.

As you can see, Mr. Chairman, there is acknowledgement from the highest levels of government that the credit crunch is real, and that a major factor behind its sustained life is the oppressive regulatory burden forced on the Nation's banks. In attempting to deal with the regulatory burden it is important to recognize that it is not just bankers tired of compiling irrelevant, time- and money-consuming paperwork that could be better allocated toward making job-creating loans. It is also a state of mind. It is a mind-set among examiners and regulators that drives them toward a harsh interpretation of laws and regulations. It is bankers fearing not only that the regulators are peering over their shoulders and second guessing every decision they make, but that Congress is micromanaging their banks and imposing itself into the everyday decisions of their business.

We have been so concerned that the regulatory burden is preventing us from making small business loans that in December we initiated a joint effort with the other major banking and thrift trade associations to urge then President elect Clinton to take steps to increase small business lending through regulatory burden relief. That effort resulted in a joint letter, a copy of which is attached, which set forth regulatory and legislative initiatives which the groups identified as most likely

to stimulate job creation. It is important to note that all of these recommendations are within the bounds of retaining a safe and sound banking system and all the recommendations focus on getting banks to lend again.

Our concern about the cost of the regulatory burden is not new. We worked hard in 1991 for a truly narrow bill without the regulatory overkill contained in FDICIA. Last year, Chairman Greenspan challenged the IBAA to provide documentation of the high costs of over-regulation. The IBAA met this challenge with a recently completed study which was conducted on our behalf by the accounting and consulting firm of Grant Thornton. The study, a copy of which is attached, estimates that the annual cost for community banks to comply with just 13 pre-Federal Deposit Insurance Corporation Improvement Act (FDICIA) regulations is $3.2 billion. Extrapolating this number to the entire banking industry, we estimate that complying with these 13 regulations—a fraction of the rules that govern the industry—costs $11 billion annually. Community banks are spending 48 million hours annually complying with these 13 regulatory areas, rather than engaging in the business of lending.

The study also substantiates the report by the Federal Financial Institutions Examination Council (FFIEC), issued late last year, which concluded that the annual compliance cost for banks in regulatory areas may be as high as $17.5 billion. Comparing this estimate with the results found in our study, it is clear that the FFIEC estimate is low. Furthermore, the study supports the FFIEC assertion that the smaller banks face a disproportionate share of the burden. The Grant Thornton study offers definitive evidence that banks with assets under $30 million incur three to four times the compliance cost of larger banks.

In 1992, we strongly supported President Bush's regulatory relief initiatives. And now President Clinton has indicated he understands the problems and will propose corrective actions. While the details are sketchy, published reports indicate that the Administration will attempt through the regulatory process to increase the ability of banks to make character loans, to establish a due process system for appeals of regulatory decisions, and to reduce some paperwork by eliminating duplication. Small and medium sized business loans apparently will be encouraged by minimizing the paperwork on these loans for well-capitalized banks. The agencies will apparently modify their procedures in reviewing loans for classification and loan loss provision. We also understand that unnecessary real estate appraisal requirements will be revised in order to encourage more lending.

These initiatives are important first steps to ease the credit crunch, for which we are very grateful, and which we strongly support. Although it appears the President's plan does not approach the scope of the industry's recommendations, the President is to be congratulated for this important initiative.

Administrative action alone will not be enough, however. It is our firm belief that legislative action is required to reverse some of the psychological harm caused by FDICIA. As long as the micromanagement provisions of FDICIA are in place, regulators will point to the law as their mandate, and bankers will continue to be concerned about each of their actions being second-guessed.

It is important that Congress also take an active part in restoring prudent character lending. The Clinton Administration and the regulators cannot do it alone. The 1989 savings and loan legislation CFIRREA and FDICIA were Congressional attempts to micro-manage the bank regulatory agencies, which, in turn, have attempted to micro-manage banking. These laws did not adequately differentiate between the disastrous S and L debacle and the manageable problems of the banking industry. These attempts at micro-management are all too often delegated to young inexperienced examiners with unbelievable powers-examiners who have never worked in the private sector and without first hand banking experience.

While FDICIA was promoted as a way to secure a safe and sound banking system, we contend that it will actually impede the ability of banks to act safely and soundly. For example, Section 132 of FDICIA requires Federal bank regulators to set Nationwide standards for a wide variety of bank internal procedures, including a bank's internal controls, loan documentation practices, credit underwriting standards, interest rate risk exposure, asset growth, ratio of classified assets to capital, earnings, and stock valuation. Section 132 is a Congressional order to the bank regulators to micro-manage the affairs of our financial institutions. The result will be a formula approach to lending with regulations written to the lowest common denominator. Banks' ability to be innovative and creative in responding to small business loan needs will be lost.

This micromanagement constrains bankers by limiting their flexibility in meeting community credit needs. Many small businesses will fail to obtain credit and fewer loans will be made because of this legislative straightjacket. The pendulum has swung too far. We are asking Congress to reverse the momentum by repealing many

provisions of FDICIA, particularly Section 132. Regulators would still retain the ability they had before Section 132 was enacted to stop unsafe and unsound practices at individual institutions, since these provisions are already addressed in existing policy statements, regulations, or guidelines.

I would also like to take a moment, Mr. Chairman, to respond to some of those who believe that the current level of regulation is either appropriate or should be intensified. For example, Comptroller General Charles A. Bowsher, testifying before the House Banking Committee, recently called for increased regulation. He said that "the regulators' approach to determining bank and thrift safety and soundness is too often playing catch-up due to limited scope examinations...A lack of minimum examination and inspection requirements is limiting the effectiveness of examiners." Bowsher based these conclusive, though misleading, statements on a GAO study of 58 bank examinations performed between 1989 and 1991. The world of 1993 is considerably different than that of 1989 to 1991. Today's world is one in which FDICIA has forced the regulators to perform more stringent and more frequent exams than the world examined by the GAO.

There should be no doubt that FDICIA has caused significant over-regulation. The information we are getting from our bankers demonstrates that the GAO's findings are not representative of the post-FDICIA world. For example, we recently received a letter from a banker who said that his $40 million-asset bank was examined last fall by 8 examiners for approximately 6 weeks. He wrote that as a result:

> We become a 10-month business. We virtually shut down for 2 months preparing for the exam and during it. Business development is out of the question and simply maintaining the service level for our existing customers is a struggle.
>
> A copy of the letter from the banker and request for information he received from the Comptroller of the Currency is attached to my testimony.

We do not dispute the need to examine all banks regularly. The health of the industry and the deposit insurance system depends on that. But placing examiners in a healthy bank for almost 2 months out of the year is overkill. This overkill hurts borrowers and the overall economy; the economic health of our communities is threatened. We urge you to ignore outdated and inaccurate studies such as the one produced by the GAO and do what you can to lift the regulatory burden.

I also want to express my concern about another factor that could create difficulties for borrowers to gain access to credit. Bankers are watching helplessly as maturing certificates of deposits exit their vaults and flow into the hands of the swelling mutual fund industry. Historically, low interest rates have combined with the additional costs imposed by over-regulation by such laws as FDICIA and Truth-in-Savings and escalating deposit insurance premiums to prevent banks from competing with mutual funds. I only hope that banks' competetiveness will improve and that deposits will return. If they do not, it could further inhibit economic growth. Deposits are the source of a bank's ability to lend, while a mutual fund has yet to make any loan.

Let me also comment on two other proposals which have been receiving considerable attention. One would create a system of new community development banks, while the other would attempt to create a secondary market for small business loans.

President Clinton has proposed the creation of up to 100 community development banks as one means of increasing lending, both residential and commercial, to the Nation's distressed neighborhoods. This proposal was motivated by the President's understandably favorable impressions of the accomplishments of South Shore Bank of Chicago and the Elk Horn Bank of Arkansas. It is our view that an increase in community development banking could have a marginally positive impact on lending. We believe, however, that the creation of 100 entities would be ineffective, inefficient, and expensive. Instead, we recommend that increased community development banking be promoted by motivating existing institutions, many of which already have expertise and experience in this field, through the use of incentives, such as tax breaks, additional CRA credits, and funding for training and technical help. Perhaps the SBA could play an increased role in this area as well. Since we represent the Nation's community banks, we are hopeful of having a meaningful dialogue with the Administration on this matter.

There have been two proposals so far which would attempt to create a secondary market for small business loans. One would create a new Government Sponsored Enterprise (GSE), while the other would change the securities, banking, and tax laws with the hope that these changes would lead to a market-created solution. Upon closer review of these proposals, we are concerned that if there is a government credit enhancement, business may be driven out of depository institutions, es-

pecially community banks, and into the laps of non-bank competitors. This is one of the potential problems with this approach. In addition, the reality of the secondary market demands that the packaged loans would be required to be standardized. They would have to fill a one-size-fits-all description that meets the needs of investors, but ignores those of the borrowers. This ignores the nature of the small business loan, each of which is unique and relies upon factors which can't fit into a cookie-cutter mold. In addition to the question of whether a new GSE would have significant competitive advantages over commercial banks by virtue of its government subsidy, is the question of whether a new GSE would create additional taxpayer exposure. It is also unclear whether small banks, with their relatively lower loan limits, would have ready access to such a market. These are just a few of the issues that should be addressed before Congress goes down this path.

Other legislative action, unrelated to FDICIA, would also prove helpful in opening the credit spigot. In particular, we want to congratulate you, Mr. Chairman, for your efforts to pass the amendments to the Paperwork Reduction Act. I pledge our continued support for this important initiative. We also urge your support for legislation to reform the bankruptcy system and to make clear that secured lenders who have caused no environmental damage will not be required to pay for environmental cleanups.

> As mentioned in the joint industry letter to President Clinton, banks are reluctant to lend to many businesses, particularly small businesses such as gasoline filling stations, dry cleaners, printers, and even farmers, which may use hazardous chemicals because of the fear that a bank's environmental liability could far exceed the amount of an outstanding loan. It is important for bankers to consider environmental factors in making their lending decisions, but owners and operators, rather than lenders which have not caused pollution, should be responsible for cleanup costs.

While last year's EPA rule provides some useful guidance, it did not address all of the problem. More importantly, the rule has been challenged in court and may be tied up for years. It is our understanding that Senator D'Amato will soon introduce a lender liability bill and we urge you to support its passage.

With regard to the need to pass bankruptcy reform, the joint letter noted that:

> Bankruptcy filings have increased dramatically during the last several years. Many of these filings abuse the system and have resulted in increased bank losses. These losses have discouraged many bankers from lending to businesses where the risk of bankruptcy is relatively high. This reluctance to lend translates into the creation of fewer jobs. Bankruptcy abuses have also increased the cost of credit to both consumers and businesses, thereby reducing economic growth.
>
> The IBAA endorses the efforts of Senators Heflin and Grassley to reform the bankruptcy laws, although we would ask that further hearings be held on the extension of Chapter 12 for family farmers.

In conclusion, Mr. Chairman, the President, the Chairman of the Federal Reserve, and many members of Congress have recognized that community bank are facing a tremendous regulatory burden, and that the regulatory burden is one of the predominate causes of the credit crunch. Over-regulation and over-documentation are adversely affecting small-business lending in particular, hampering the most dynamic, job-creating sector of our economy. I don't believe that I can summarize the problem any more eloquently than the conclusion of an article entitled "Why Banks Are Still Stingy," which appeared in the January 25, 1993 edition of magazine: "If the new Administration doesn't find a way to open the credit markets to small business, this potential economic powerhouse for the 1990s will short out."

December 7, 1992.

President-elect Bill Clinton,
Governor State of Arkansas,
Governor's Office,
State Capitol,
Little Rock, AR 72201.

Dear Mr. President-elect: During your campaign you made clear that increasing economic growth and job creation would be your top priority. The undersigned associations, which represent the entire banking industry, share this priority. We are writing to recommend several steps supported by the entire banking industry that you can undertake in the first few weeks of your administration to promote the flow

of credit to businesses and consumers, thereby enhancing job creation and economic growth.

First, we are enclosing specific, targeted recommendations designed to eliminate the unnecessary regulatory burdens and paperwork that impede economic growth. These proposals would remove barriers to new, job-creating bank lending and can be implemented without undermining public confidence in the safety and soundness of our industry. Several of these recommendations can be accomplished quickly by executive order or by regulation. Others will require legislative action, and we urge that they be included in the economic stimulus package you will present to Congress in January. All have a clear link to creating new jobs and have no adverse budgetary impact.

Second, it is critical that you promptly appoint highly qualified individuals who are knowledgeable about the industry to the Treasury Department and the financial regulatory agencies. They should be committed to implementing a more balanced approach to bank supervision and regulation. As you pointed out during the campaign, regulatory overreaction has stifled bank lending and postponed economic recovery.

Third, in addition to our other recommendations, we urge your support for proposals that have already made considerable progress in the Congress—reform of bankruptcy laws and making clear that secured lenders who have caused no environmental damage will not be required to pay for environmental cleanups. Notably, bankruptcy reform legislation passed both the House and Senate in 1992 without a single dissenting vote. Also, legislation dealing with environmental liability, co-sponsored by a large majority of House members, has passed the Senate several times.

Banks are reluctant to lend to many businesses, particularly small businesses such as gasoline filling stations, dry cleaners, printers, and even farmers, which may use hazardous chemicals because of the fear that a bank's environmental liability could far exceed the amount of an outstanding loan. It is important for bankers to consider environmental factors in making their lending decisions, but owners and operators, rather than lenders which have not caused pollution, should be responsible for cleanup costs.

Similarly, bankruptcy filings have increased dramatically during the last several years. Many of these filings abuse the system and have resulted in increased bank losses. These losses have discouraged many bankers from lending to businesses where the risk of bankruptcy is relatively high. This reluctance to lend translates into the creation of fewer jobs. Bankruptcy abuses have also increased the cost of credit to both consumers and businesses, thereby reducing economic growth.

Fourth, we urge you to request the Congress to promptly meet its obligation to fully fund the Resolution Trust Corporation and the Savings Association Insurance Fund. This will help maintain public confidence in the financial system by honoring the Federal Government's commitment to depositors and help stability the Nation's real estate markets.

Fifth, as bankers we are closely involved in local economic development and are very interested in your community development bank proposal. We are eager to work with you and your administration on proposals to increase economic activity in areas where it is especially needed.

We thank you for this chance to present our recommendations and would welcome the opportunity to discuss them with you. We look forward to working with you.

Sincerely,

William H. Brandon, Jr.,
President.

Robert W. Hawkins,
President, Independent Bankers Association of America.

Richard M. Rosenberg,
President, Association of Reserve City Bankers.

Samuel A. McCullough,
Chairman, Association of Bank Holding Companies.

Douglas K. Freeman,
Chairman, Consumer Bankers Association.

Gerald J. Pittenger,
Chairman, Savings Community Bankers of America.

JOB-CREATING REGULATORY RELIEF BY ADMINISTRATIVE ACTION

During the campaign, President-elect Clinton linked regulatory overkill with concerns about the availability of credit and its impact on economic growth. The regulatory burden needs to be addressed in many instances through legislation. But until then, the bank regulatory agencies should be encouraged to adopt a balanced and reasonable approach to regulations implementing current law. In particular, the bank regulatory agencies should be encouraged to develop regulatory standards which rely on banks' existing internal policies and procedures to the maximum extent possible.

Small business is the job-creating engine in the United States and regulatory overkill is adversely affecting small business lending. Looking towards eliminating regulatory overkill and micromanagement, President-elect Clinton can take the following actions quickly, by executive order and/or agency action, to increase banks' job-creating lending to consumers and business, particularly small business.

1. RESTORE CHARACTER LENDING

The banking business involves risk and judgment. Character lending requires a blend of risk assessment and character judgment by the bankers. However, this former staple of bank lending is being regulated out of existence. Federal Reserve Board Chairman Greenspan recently stated that the "most recent thrust of legislation, and the associated supervision, has eliminated the so-called character loans that had so dominated lending practices of a large number of banks to individuals and small business."

Regulatory mandates and practices attempt to replace banker judgment with ratios and formula lending. If this unfortunate goal is accomplished, this country will lose one of its most valuable assets—banks that are willing to take some risk and make loans to creditworthy borrowers. The potential borrowers who will be most adversely affected are the small businesses that are the backbone of job creation in our economy.

Job-Creating Relief: President-elect Clinton should encourage regulators and examiners to recognize that banking involves calculated risks and that character loans do not warrant blanket criticism. Serving the credit and deposit needs of the variety of small businesses, the assortment of industries, and the diversity of consumer needs in this country requires a banking industry that is willing to take prudent risks without fear of excessive regulatory sanctions and penalties.

2. RESTORE DUE PROCESS—CREATE AN APPEAL PROCESS

Recent legislation has placed increased emphasis on penalizing institutions that violate law or regulation. This threat of civil money penalties and other sanctions is forcing banks to be overly cautious, dampening their enthusiasm for lending. Examination results are used to levy significant money penalties or enforcement actions against officers and directors, even for technical infractions such as inadvertent addition errors on regulatory reports. Business and individual assets are being frozen without the benefits of due process protections. An enforcement action can result in an institution being closed early, having its growth restricted, dividends limited, and directors and officers dismissed—all of which discourage banks from actively seeking new lending opportunities.

The agencies' current appeals process does not provide due process because appeals are directed to examiners' supervisors, not decisionmakers who are clearly objective. This further exacerbates the environment of fear. Bankers are reluctant to make sound loans that might fall to meet technical requirements.

Job-Creating Relief: President-elect Clinton should request that the agencies create an appeals process conducted by objective, high-level decisionmakers. The process should permit institutions to contest an examination finding or request a review of a regulatory determination without fear of retribution. It should also permit institutions to contest their capital classification under the prompt corrective action rules. Creating an effective appeals process would send bankers a message that meaningful recourse is available if they disagree with an examiner's conclusions. This would encourage banks to be more aggressive in seeking new business and lending opportunities.

3. RESTORE REASONABLENESS TO ACCOUNTING PRINCIPLES

Current law permits the regulators to impose more stringent accounting rules on financial institutions than required by Generally Accepted Accounting Principles (GAAP). In some instances, the regulators are using this authority to impose Regu-

latory Accounting Practices (RAP) that further restrict credit. RAP place banks at a competitive disadvantage with other nonbank providers of credit. Differences between GAAP and RAP also add to banks' reporting burden, requiring different reports for the regulators and the public. Differences in the accounting treatment of loans sold with recourse hinder banks' ability to effectively utilize the secondary market and require unnecessary capital support, both of which serve to deter aggressive lending.

Job-Creating Relief: President-elect Clinton should discourage the regulators from deviating from Generally Accepted Accounting Principles (GAAP), particularly where the result further impedes banks' willingness to lend and places them at a competitive disadvantage with nonbank lenders. The agencies should be directed to eliminate the inconsistencies of RAP and conform with GAAP for loans sold with recourse in determining the amount of capital, which would be completely consistent with the principles of safety and soundness.

4. ELIMINATE MARKET VALUE ACCOUNTING FOR BANKS

The Securities and Exchange Commission (SEC) has been urging the Financial Accounting Standards Board (FASB) to require banks to apply market value accounting to the entire balance sheet. Market value accounting basically requires the valuation of an asset as if it were being sold today, regardless of the asset's maturity. A bank's primary business is to make illiquid commercial loans with the intent of holding them until maturity. Federal Reserve Chairman Greenspan noted that this is "the competitive reason for banks' existence and their special expertise."Many commercial loans, particularly small business loans, lack ready markets that would enable a bank to "value" the loan as if it were selling the loan today. Chairman Greenspan said that "commercial loans generally do not fit into standard packages that are easily priced." This is because these loans are often made to unrated companies based upon the bank's credit judgment of the borrower's character, as well as the company's unaudited financial statements. Chairman Greenspan also stated that "applying liquidating values to instruments not meant to be liquidated prior to maturity is a misapplication of accounting principles." The conclusion is that market value accounting is unworkable.

Market value accounting will decrease banks' willingness to lend. Current proposals already discourage banks from investing in local municipal bond issues, many of which are non-rated and have no ready markets. Market value accounting of debt and equity securities will cause significant earnings fluctuations and affect banks' capital levels. This volatility will further hinder lending.

Job-Creating Relief: President-elect Clinton should urge the SEC and FASB to recognize that market value accounting is not workable and will have a detrimental effect on banks' lending and the overall economy. The accounting agencies should adopt an accounting standard that recognizes that banks are special, that their job is to make illiquid investments in the form of loans to borrowers they judge to be creditworthy, and that market value accounting cannot be imposed on the banking industry without severe repercussions on banks' lending and the economy.

5. MINIMIZE EXAMINATION DISRUPTION

Agencies conduct examinations for safety and soundness, consumer compliance, trust, EDP, CRA and other purposes. Currently, only limited coordination is undertaken by the agencies to reduce the amount of time an institution must dedicate to examinations. As a result, banks can be forced to host examiners for weeks at a time, dedicating their staff to answering examiner questions and needs, rather than making loans or doing bank business.

Job-Creating Relief: President Elect Clinton should direct the Federal regulators to coordinate all bank examinations (e.g. safety and soundness, consumer compliance, CRA, EDP, and others) in order to minimize the disruptive effects of such examinations on bank operations, permitting banks to place greater focus on the business of banking-lending.

6. USE CAPITAL STANDARDS APPROIRIATELY

Capital is an important indicator of a bank's financial health, but it is not the only factor that reflects a bank's financial condition. To fully assess the condition of a bank, the regulators have relied upon a rating system called "CAMEL," which evaluates banks for Capital, Asset quality, quality of Management, stability of Earnings, and Liquidity levels.

The FDIC Improvement Act requires the regulators to take "prompt correction action" against banks based solely on three capital levels. This means that, effective

December 19, 1992, based only on where a bank falls in the five capital categories, it can be closed early, have its premiums increased, growth restricted, dividends limited, and directors and officers dismissed. Regulators have the added authority to lower, but never raise, a bank's capital ranking.

Relying solely on capital is not a prudent means by which to evaluate the industry. This focus on capital is forcing banks to raise higher and higher amounts of capital, and is discouraging lending. In addition, the reporting required to monitor compliance with the rule is significant. Continuous fine-tuning of these capital standards poses an additional burden.

Job-Creating Relief: Banks meeting regulatory capital and other supervisory standards are penalized when regulatory standards designed for high-risk institutions are applied to all banks, low-risk and high-risk alike. This results in unnecessary costs for low-risk banks and a poor use of capital. The economy would be better served if the bank regulatory agencies were encouraged to provide banks meeting regulatory and other supervisory standards with lower costs through a reduced regulatory burden.

President-elect Clinton should direct the regulators to exercise their discretion to apply a more balanced approach to evaluating banks, relying more on the balanced "CAMEL" system and the similar "MACRO" system for savings institutions to the extent they can, rather than just capital. The regulators should also review the compliance burdens that these capital rules have placed on banks and reduce them where possible. The regulators should be directed to avoid repeated changes to the capital rules, including risk-based capital.

7. PAPERWORK REDUCTION FOR CRA AND OTHER RULES

The Community Reinvestment Act (CRA) and regulatory practices, such as requiring formal written policies for everything, are creating situations that foster documentation and paperwork and ignore performance. Regulators have been looking for banks to create big files and long policies to meet CRA requirements rather than looking at what banks are doing in their communities. Regulatory policy statements that focus on paperwork rather than actual lending programs are also a hindrance to lending.

Job-Creating Relief: President-elect Clinton should encourage the agencies to focus on what banks are actually doing to serve their communities, rather than documentation. The agencies should be discouraged from requiring expensive geographic and demographic analyses of lending and deposit activity, particularly in rural and small communities. Focusing on how a bank is meeting its community credit needs is a more productive answer to community reinvestment concerns than the current focus on paperwork and documentation.

8. ELIMINATE DUPLICATIVE APPRAISAL REQUIREMENTS

Examiners are requiring banks to create internal appraisal review processes and are often requiring banks to obtain second and even third appraisals for loans if they disagree with the current appraisal. This second guessing by examiners is greatly increasing borrowers' loan costs and is hampering banks' lending.

Job-Creating Relief: President-elect Clinton should discourage the regulators from requiring duplicative appraisals on loans that fail to raise a significant safety and soundness concern. This is an unnecessary impediment to bank lending and is hurting small business borrowers.

Needed Legislative Changes To Boost Economic Grow in Local Communities

The incoming Administration can propose a number of immediate legislative steps in its jobs initiative to provide the economic stimulus to banks to jump start our stagnant economy. By eliminating certain impediments to lending, significant amounts of additional capital will be freed up to lend to small businesses, consumers and others this creates jobs, promotes growth, and enhances public confidence in a speedy economic recovery which, in turn, acts as a catalyst to even greater economic growth. Moreover, reducing bank costs means lower cost to consumers, further encouraging economic expansion. Enacting these legislative changes will in no way jeopardize the safety and soundness of our Nation's banking institutions, and would represent an important "first step" towards long-term economic recovery.

The following targeted legislative steps have been identified by the banking industry at this time as provisions which should be included in the Clinton Administration's economic growth plan.

1. *Eliminate Supervisory Overreaction*—Legislative responses to thrift industry problems (FIRREA in 1989) and its fallout for the banking industry (the Crime bill of 1990 and FDICIA in 1991) have imposed a formal and inflexible lending process. If this process is violated, lending officers, bank management and financial institutions could be subject to up to $1 million per day civil money penalties (12 U.S.C. 1818), as well as have their personal and business assets frozen (12 U.S.C. 1818(c)(1) and 1818(i)(4)). This has driven many qualified people from the industry and has prevented lending officers from making, and boards from approving, other-than-perfect loans for fear of retribution, thereby lessening the flow of credit to small businesses and others, limiting employment growth, and undermining local economies.

More flexible credit judgment needs to be restored to the lending process, allowing lenders to take more credit risks on borrowers. Current penalty provisions need to be modified to consider the size and the impact of the infraction when setting the appropriate penalty; maximum penalties need to be reduced. Due process protections need to be restored to ensure that personal and business assets cannot be frozen without adequate judicial review. Culpability standards should be reviewed to ensure that ordinary business judgments will not be subject to second-guessing and "hindsight" liability.

2. *Eliminate Micromanagement of Bank Operations*—Bank regulation is best practiced on a case-by-case basis, tailoring supervisory intervention to the specific problems of the institution. This ensures the safe and sound operation of banks and promotes flexibility in the credit granting process so that banks can tailor their credit decisions to community needs. In such an environment, businesses flourish and jobs are created.

A legislative mandate in FDICIA (Section 132), however, requires Federal bank regulators in Washington to set Nationwide standards for a wide variety of bank internal procedures, including a bank's internal controls, loan documentation practices, credit underwriting standards, interest rate risk exposure, asset growth, ratio of classified assets to capital, earnings, and stock valuation, regardless of whether these standards are appropriate for individual institutions. Congress has sent a clear message that Federal regulators should micromanage the affairs of our financial institutions.

This micromanagement operates as a "straitjacket" on bank operations. It limits bank flexibility in meeting community credit needs—many small businesses fail to obtain credit and fewer jobs are created. Precious financial and human resources, which could otherwise be used for making loans, are tied up in unnecessary regulatory paperwork. The FDICIA provision should be repealed, thereby sending a useful signal to regulators to avoid micromanaging banks under existing laws and policies. Regulators would still retain the authority to stop unsafe and unsound practices at individual institutions, without the legislative mandate to intervene at every bank in the country.

3. *Increase Community Lending by CRA Incentives and Reduced Paperwork*—The banking industry recognizes its important role in helping to meet the credit needs of local communities. However, the Community Reinvestment Act of 1977 (12 U.S.C. 2901 et seq.), which started out as a restatement of that responsibility, has evolved into a paperwork nightmare which diverts vital bank resources away from serving that function. The President-elect has already stated his concerns over CRA paperwork. Federal regulators should be legislatively directed to reduce CRA paperwork requirements and eliminate policies that effectively require the creation of "paper trails."

The incoming Administration should also explore whether other incentives may be created to help meet CRA objectives and encourage additional investment in our Nation's communities. For example, CRA should be amended so that banks will receive credit for investments in joint ventures that invest in communities outside local areas of bank operation. Moreover, safe harbors from challenges should be granted to banks with good CRA performnances in order to reward good CRA efforts. The incoming Administration, working with industry groups and other interested parties, should explore whether other incentives may be created to spur additional CRA lending. Finally, the Administration should apply CRA statutory responsibilities on other types of institutions which are important sources of investment and lending capital.

Each of these suggestions will work towards revitalizing local communities and boosting economic expansion.

4. *Restore Reason to Accounting and Auditing Practices*—Recent congressional action (Section 121 of FDICIA, which requires regulators to develop a method by which banks can supplementally disclose the fair market value of assets and liabilities) and regulatory debate by the Financial Accounting Standards Board (at the

urging of the SEC) represents a movement towards imposing market value accounting on all bank assets and liabilities. Such a movement should be viewed with extreme caution because of its potential disastrous affects on credit availability. The bank trade associations strongly recommend against moving in this direction.

Forcing a bank to value investments and loans to current market value significantly decreases a bank's willingness to lend. For example, forcing banks to mark-to-market securities holdings will increase the volatility of bank earnings and capital levels, making it more difficult to match long-term assets with short-term liabilities, and discourages banks from providing long-term investments in their local communities. Similarly, applying market value accounting to bank loans also presents problems: because no secondary market exists for small business loans, any market valuations which take into account loan performance or the creditworthiness of bank borrowers would be very subjective and difficult to make. Market value accounting for these types of assets would be inappropriate and would seriously complicate a bank's ability to lend.

The recent legislative enactment (Section 121 of FDICIA), which moves towards market value accounting, should be repealed.

The incoming Administration should also consider eliminating unnecessary auditing costs, imposed by recent legislative enactments, which act as a brake on further economic recovery. Stringent new auditing requirements imposed upon independent auditors under FDICIA (Section 112) have transferred bank supervisory responsibilities to auditors, forcing them to assess a bank's compliance with safety and soundness regulations and subjecting them to significant liability for faulty judgments. This seriously drives up audit costs and creates incentives for auditors to eliminate risk from the credit-granting process. This artificially inhibits bank lending and delays econonuc recovery. Current auditor attestation requirements in Section 112 of FDICIA involving safety and soundness regulations should be repealed, with the responsibility for making such judgments left to Federal regulators. In this way, bank safety and soundness would not be jeopardized and an important impediment to bank lending would be removed.

The Administration should also recommend the repeal of provisions in Section 112 of FDICIA creating duplicative management report requirements and certain other restrictions on the makeup of internal bank audit committees. The former unnecessarily drives up bank and consumer costs; the latter forces certain directors off of bank audit committees, denying banks the benefit of the advice of competent individuals capable of accurately assessing the creditworthiness of potential borrowers. This, too, may impede the ability of banks to take sound risks and fuel a strong economic recovery. In order to ease the impact of the remaining portions of the FDICIA provisions and provide for an orderly transition to the new rules, the Administration should also consider delaying the effective date of the remaining provisions.

5. *Eliminate Technical Impediments to Accepting Public Deposits*—Current law (12 U.S.C. 1823(e)) may impose certain technical limitations on the ability of banks to provide public entities with adequate collateral to secure sizable public deposits. As a result, many public entities are considering removing these deposits from local banks, depriving banks of important sources of funding used to finance economic development. Inappropriate limitations on the ability to provide adequate collateral should be removed.

6. *Modify Limits on Loans to Officers, Directors and Shareholders*—Recent statutory changes to (Section 306 of FDICIA) imposed new limitations on the ability of banks to meet the credit needs of bank officers, directors, shareholders, and related parties, potentially restricting the ability of banks to fund local economic development. Because many business leaders in communities serve on the boards of banks from whom they obtain their primary business credit, these statutory changes force banks to choose between lending to local businesses and retaining these qualified business leaders as bank officers and directors. Numerous banks will be faced with the dilemma of choosing between informed leadership and making job-creating loans.

The incoming Administration should consider the impact of these new loan limitations on financial institutions and provide limited additional flexibility to Federal regulators in providing exemptions to these rules. Regulators should rely upon the annual exam process and other supervisory tools to ensure that abuses in this area are uncovered, rather than impose blanket limitations on all banks.

7. *Better Understand the Impact That Bank Capital Standards Have on Credit*—Recent congressional actions have placed a strong emphasis on increasing bank capital levels as a means of cushioning against future credit risks and protecting Federal deposit insurance funds from loss. The banking industry strongly believes that

financial institutions should possess adequate capital to cushion against loss. As such, it is generally supportive of congressional efforts to assure strong bank capital levels, such as through the implementation of the prompt corrective action sections of FDICIA, which impose a tiered approach to bank supervision.

However, the incoming Administration should consider the impact that changes in capital levels have on the availability of credit. Capital rules, if carried too far, can have the effect of diminishing a bank's ability and willingness to lend by tying up a significant amount of funds that could otherwise be leveraged into bank loans and by unintentionally creating a scheme of credit allocation. The Administration should closely review any further change to bank capital rules for its impact on credit availability.

Moreover, the Administration should consider three immediate changes to the capital standards contained in FDICIA (Sections 131 and 305) in order to increase the availability of credit to local communities:

(a) Increase the flexibility of Federal regulators to consider "other appropriate factors" in determining an institution's capital classification. Under the current prompt corrective action provisions of FDICIA (Section 131), an institution's capital level is the primary factor in determining whether it will be subject to regulatory sanctions, including linuts on growth. While capital is important, it should not be the only measure determining a bank's classification; other measures should also be considered where appropriate (including, but not limited to, such things as management expertise, earnings history, and asset quality). This will prevent otherwise healthy institutions from being subject to restrictions which reduce their ability to meet local credit needs.

(b) Repeal the provisions in FDICIA that require bank regulatory agencies to develop capital standards to account for concentration risk and non-traditional activities risk (Section 305 of FDICIA). Standards in both cases will necessarily be arbitrary and potentially costly to banks, particularly for those already meeting existing regulatory capital standards. The bank regulatory agencies have adequate authority to deal with particular risks posed by engaging in unsafe and unsound banking practices, and both concentration risk and non-traditional activities risk are best addressed by the agencies under those existing authorities. In order to minimize the international competitiveness implications of U.S. capital rules, the Administration should also consider phasing-in the inclusion of interest rate risk in capital calculations (as required under Section 305 of FDICIA) to correspond to the implementation of similar international capital standards.

(c) Create an effective regulatory appeals process to permit review of capital classifications under the prompt corrective action provisions (Section 131 of FDICIA). An institution's capital classification has a significant impact upon the ability of that institution to make independent credit decisions affecting local economic growth. These institutions should have the ability to appeal capital classifications to an independent source prior to becoming subject to regulatory sanctions.

8. *Eliminate Anti-Growth in Impediments in the Real Estate Appraisal Process*—Current statutory rules on the appraisal process increase consumer costs and place unnecessary impediments to economic development. The incoming Administration should closely review existing statutory rules on real estate appraisals to ensure that such impediments are minimized. For example, banks operating on state borders currently have problems using qualified appraisers licensed in one state but not the other. This delays loan processing and potentially drives up bank and customer appraisal costs. The Administration should consider legislative ways to alleviate this cross-border reciprocity problem.

9. *Minimize Credit Restraints in Bank Regulation*—Regulatory examinations clearly represent an integral part of the supervisory process. However, certain aspects of both existing exam requirements and the new requirements of FDICIA will unnecessarily hinder the ability of well-run banks to operate efficiently to meet local credit needs.

Financial institutions are currently subject to a variety of examinations, often from both state and Federal sources, at different times of the year. These examinations represent a costly and serious intrusion into everyday bank operations, tying up bank management and other resources for weeks at a time, and keeping these resources from being used to promote further economic growth. Efforts should be made to increase regulatory flexibility in this area and minimize both the costs and the disruptive effects of the current exam process, while maintaining the integrity of the general process.

The incoming Administration should consider modifying current laws on examination requirements to: permit strong community banks to be examined every 2 years; allow state examinations to satisfy Federal examination requirements; and

allow banks within a multibank holding company to be examined less frequently under certain limited conditions (which ensure that safety and soundness is maintained). These minimal changes will reduce bank costs and permit more time to be spent meeting local credit needs.

Senator LIEBERMAN. Thank you, Mr. Lauffer.

You are both excellent because your testimony is practical and from Main Street, which is what we are obviously concerned about. I am really struck by your last point, Mr. Lauffer, because one of the things that has become common wisdom here is that if the banks are giving 3 percent for our money and can get 6 percent for putting it into a government security, why take the risk of making a loan to a small business? But part of what you are saying—and, of course, we all know it is true—is that there is beginning to be a tremendous outflow from that basic CD pool because the rate is 3 percent, so people are going into mutual funds and other instruments.

Mr. Brandon, your testimony was excellent because it gave us real-case examples and, in that sense, responded to something I wanted to ask you. And this is what the critics have charged. This Committee is small-business oriented, admittedly, because that is our focus. We are not banking-regulated oriented. So we tend to want to see things happen that will make it easier for small businesses to borrow money.

One of the criticisms of some of the regulatory changes that have been talked about is that perhaps the banks are going to take advantage of this moment when lending is down for various reasons to try to eliminate a lot of regulation that is really not inhibiting lending. It may be something the banks do not want to do, but it is really not centrally related to those lending decisions. You gave some examples, clearly, of regulations which are inhibiting your desire to loan.

How would you answer generally to that criticism?

Mr. BRANDON. You know, we support a bill S. 265, so that we have something to focus on, something to set the parameters of debate. And in that bill, I kind of consider it a as a mosaic, and there is a thread running all the way through that thing. The issues that I brought up in those five loans that I talked about run all through the bill that we support.

The one thing, though, that we want to really focus on and emphasize in that bill is the things that it does not do. And safety and soundness, in our minds, are not affected by that bill. For example, we do not in that bill talk about capital requirements. We do not in that bill talk about early innovation. That is left alone. We do not in that bill talk about change in broker deposits; we do not talk about change in the risk-based premiums. Those things that are in there and that are necessary for the safety and soundness we have not talked about.

What we have talked about, very simply, is those things that hinder lending primarily to small business. I think if you would see that, a lot of those points that we made in that bill run back to the same points that I brought up before. You have got no exceptions; you have got strict lending laws that make it almost impossible to do real estate lending that is tied to character loans. You have

made it very difficult, through some of the processes of no exceptions, to have small companies be made loans.

Our whole approach on the thing is to identify those things that will hinder lending and hinder the success of small banks in small towns as well as large banks and, therefore, hinder the economy. We are clearly seeing something affecting the economy, and there are a lot of arguments as to what it is.

I would say, I think Governor Mullins is exactly right. We learned a lot of lessons in the 80s, and that is going to change a lot of things for the long-term future. But, at the same time, there has got to be some reason that, with the recovery starting, banking is not back in it to the extent that it could be. If we were in it to a normal extent, that would be $200 billion. If we would look at the five recessions, at this point, the banking industry would be up $200 billion in lending. We are not there. We are actually negative .6.

How much of that would be changed if we had a different attitude of the Congress and a different set of regulations and a different attitude of the regulators? And we think that all of those can be adjusted without affecting safety and soundness one bit. I am totally convinced of it. I need safety and soundness. I do not mind being examined. In fact, it is very helpful to me normally to be examined. I want safety and soundness. I simply say that what we are doing now is not working and there are ways to change it.

Senator LIEBERMAN. I think you have answered my next question in what you just said. I was going to ask you if you could pick out the two or three most significant changes that could be made by Washington to make it possible for banks to begin making the loans again.

I was struck by what Governor Mullins said about the relative health of the banking industry at this point, which is good news that ought to get out to the public. And, again, I know it is different from region to region. But what my small business folks keep saying to me is, "Look at the earnings reports of the banks in Connecticut; they're doing well again." Which is good. But we are not seeing the same kind of lending that we saw coming out of the earlier recessions.

So what would you say?

Mr. BRANDON. I wish I could. I mentioned in the first part of my testimony that it would take 100 things changing 1 percent, and if there were two or three things, that would just absolutely be wonderful.

For example, it was mentioned in here several times, secondary market for small business. I am for anything that helps small business, anything that helps small business. And there is a place where you can take your longer loans and you need to put them out, because banks normally have to loan on a much shorter basis, and we are the only ones making those loans, generally. We are the only ones making the entire spectrum of those loans from the very best down to the marginal. So there is a place for that.

On the other hand, I have a grave concern if we look and say, "That is going to turn this thing around." That is such a specialized market, and you have got to find ways to make everything kind of conform and fit in order to put it into the secondary

market. And the loans I have seen, the small business loans, all are unique; they are all on their own.

So I would say to you to look for anything that will help the small business lending, but also look at the very practical side of that, too, and maybe that alone is not going to be the answer. So that is the way to go.

People are saying, if you got the capital accounts just right. Capital is certainly a very important part of this thing, but it is just a part of this thing.

I would say there is one thing, though. If I could have one wish that it would be, I think the C-Span effect—and that is kind of a term that is being thrown around now. The C-Span effect is more powerful than anybody ever thought it would be. That is, the C-Span effect takes the attitude of the Congress and drives that through the regulators, and the regulators see what they feel is a negative attitude of the Congress.

Take the GAO. At the present time, I have an internal auditor. My bank is large enough to have an internal auditor. It takes about $75 million to get to that size, so I have got an internal auditor. He is responsible for doing what the Comptroller General of the GAO wants me to do. Then I have got a director's audit committee which is an outside auditor. They are responsible for doing what they want to do.

Then I have got the comptroller of the currency coming in and looking at me. They are responsible for doing what he wants them to do. Then you have got me. The board hires me to make sure these things are done. We have got four people doing that.

Now, you add another layer on top of that. It is not just the cost. If you think an accounting firm that is now charged with the responsibility of making sure that all of this is perfect and you think they know they are going to be sued if it is not, you think you have seen credit squeezed—I mean, it is going to slow that thing down 50 percent more.

So we are saying, "Attitude, attitude." We need to find a way to get it to where the parties can come together and find the balance again. I say we are out of balance, way out of balance. And if we can find a way to change the attitude of the Congress, change the attitude of the bankers, change the attitude of the regulators, simply to finding a solution instead of driving for a risk-free banking system, which will not work, then that is the one thing, if we could do it, I believe would start to change the whole system.

Mr. LAUFFER. Mr. Chairman, I would like to add something to that. I agree with Bill. Take the Bob Clark hearings. We are an OCC bank. And you had Congress really hanging him on a tree for all the problems that were there. We also had the young bank examiners watching C-Span, too, not only me.

At the same time, the Fed and everyone was having meetings, "Loosen up on these loans, loosen up on these loans." And I think Bill is right about the C-Span effect. There they see Clark losing his job and the regulator from hell is gone. And on the other side, they're saying, "Loosen up, loosen up." But these young examiners are watching that and they say, "My boss is gone because they are saying we were too loose." So it is better for them to cover their

butts by classifying as many loans as they can classify so that they are not criticized if that one loan goes bad.

The other thing I would like to add is, in our written testimony we outlined eight or nine points over four or five pages that specify what we feel could be done. But again, I would like to press upon you, it has to be done both on the regulatory level and on the legislative level. The regulatory alone just will not cut it, because they do not have the power you people have. And we think it has to be done some of each to get a balance so that we can get back in this situation.

I have been in banking 32 years and I am 53 years old. But each day, as you get a new reg, you feel like saying, "Forget it." You know. It is hard to make a profit, stay in business, and comply with all the things. Bank examinations, for example.

As an example of how many bankers come in on a bank, we had safety and soundness and CRA. We had 10 or 12 examiners for 4 weeks, or 5 weeks. We are going to have a compliance in 2 months with another eight or nine examiners for 3 weeks. We almost have to shut down our business because our senior officers are called to meetings, we have got to get stuff, we have to pull folders. So the effect of the regulation when they come in is even more. It is unworkable.

And small banks out in the country with less people—I have 85 people. But a bank with seven or eight people, it is almost impossible because we are jumping through the same hoops. For this $500 loan, in some respects, I have got to go through the same hoops as a $5 million loan because there is no position for size.

Senator LIEBERMAN. I think you are both not only very eloquent but very sensible and convincing, and when I listen to you and hear about the climate of regulation it does seem to me that in good measure the regulators are fighting the last war. I say that respectfully. But the sense that you refer to, the sense of the kind of burden and targeting that was done to somebody like Mr. Clark, with all the publicity on what appeared to be the excesses of the 80s and the alleged lack of sufficient regulation.

So now here we come into a climate where what we need is more liquidity in the economy, and yet, the regulatory process is, in that sense, fighting the last war, wanting to make sure that they do not get blamed for anything that happens again. So they are coming down very hard on the banks and making it harder for the banks to make loans, just when we need you to make those loans. So, hopefully, we can begin to turn that around.

The other point you make, which is very important, is that there is no magic bullet here, there is no one step we can take. Even the one thing you point to is a kind of atmospheric or attitudinal effect, that this is a legislative/regulatory approach that we have got to take to make this better.

I am going to yield to the Chairman.

The CHAIRMAN. Thank you very much, Senator Lieberman.

First of all, I want to compliment both of you on your testimony. It was compelling and sensible and practical.

Mr. Lauffer, if I may just say, I really relate when you say another new regulation comes down the pike and you say, "Who needs it." And you want to say, "Shove it, I am out of here."

I listened to Ross Perot 2 days ago come up and lecture us about ethics. And I must say,—this hearing has absolutely nothing to do with that, but—I was offended by that. You know, knock on wood, but I do not think I have ever charged the taxpayers for a first class airline ticket since I have been in politics, since I have been in the Senate. I do not think I have ever charged the taxpayers for a meal. I can do it if I want to. I just have never done it because I did not think I ought to.

The ethics manual for the United States Senate is growing faster than banking regulations. It is about that thick now. I would like to hold that up for Mr. Perot and say, you know, "You look through this and tell me what, in your business, what are the ethics in your business."

Even with that, I bet we call the Ethics Committee on average once a week because that manual still does not cover something. We are afraid to move. We are hide-bound around here. You are afraid to do constituent work anymore. You are afraid to write a letter on behalf of somebody for fear that it will show up on the front page of The Washington Post.

The place is in gridlock for a lot of reasons, not the least of which is the political terror. Everything strikes terror in the political hearts of the people around here.

But I cannot express my sympathy to you for what you are undergoing. My sympathies also lie of course, with small business people, and I will get off my soap box now and just ask you a couple of questions about the business.

As you know, the demand for 7(a) guaranteed SBA loans is growing exponentially. The increases in those loans in 1992 and 1993 do not tell the full story. We allocated money for 7(a) loans on a quarterly basis, and we ran out of money within the first 3 weeks of the quarter. We just do not make anymore because we do not have the money. Right now, we have already used up—we did get authority to transfer the last quarter to the second quarter, so that money is already gone. We have no money for the fourth quarter of this year.

The President has put in $141 million in his requests, in a supplemental. $141 million will make $2.6 billion in 7(a) loans. A step in the right direction.

But one of the reasons for 7(a) loans is not just because of the credit crunch; it is also because of the length of loans. The SBA will loan a guy money for 10 to 12 years. Now, that is unthinkable in your business; is it not?

Mr. LAUFFER. Pretty much so, without an SBA guarantee. That is right.

The CHAIRMAN. If I were to come to you and I had a small business, and let us assume it is up and running reasonably well, maybe not great profits and so on, but you like me, you think I am an honest guy and I am going to do my best to keep that business going. But nothing extraordinary about it. What kind of length of time would you give me on an operating loan?

Mr. LAUFFER. Well, it would depend on a number of things. It would depend on past experience, what the record of the business was, what type of collateral we were looking at, if the loan was a

variable rate, which most commercial loans are. So it would depend on a number of factors.

If all of those met our credit requirements, we would make it by ourself because it is easier to make a loan without the SBA guarantee. There are a lot of different hoops, and there should be a lot of different hoops, to go through. But it would depend on a number of things.

If I could comment on your ethics thing before I lose the thought, would that be all right?

The CHAIRMAN. You like that, huh?

Mr. LAUFFER. Yes. Let me try to phrase it properly.

With FIRREA and FDICIA, Congress has, by doing what they have done, I think they have said that every banker in the United States is not ethical and not fair and not honest and does not have integrity. They have written the law to cover Charles Keating, and we are not Charles Keating.

I think Bill will agree with me, knowing the bankers across the country are honorable, ethical, and have integrity of the highest level. And I think that is what has happened to you in Congress. You get one or two people——

The CHAIRMAN. Absolutely.

Mr. LAUFFER. And so you knee-jerk and write the law to cover everybody, and then you cannot effectively do your job.

The CHAIRMAN. We govern by exception rather than the rule around here.

Mr. LAUFFER. That is it exactly.

Mr. BRANDON. I want you all to notice—you probably already have but I want to make the comment anyway—that the ABA and the IBAA are here testifying saying exactly the same thing. That is bound to mean that we are right.

[Laughter.]

Mr. BRANDON. There are several other things that come into what we would do in your case. I think that banks would like to make some exceptions and really find something that is going to help their community and is good for the business and is going to establish a long-term customer, and we might make you a 12-year loan.

But if I do that today, I have got to sit back and go to my board and say, FASB is getting closer and closer to mark to market. They may make me mark that loan to market. If that is a 12-year loan, there is a present-day value I will have to come back to, and that is going to turn the tide against you getting that loan.

That is the reason I am going to go to SBA and the funds are not going to be there, is I cannot deal with that mark to market. You have got an interest rate risk that is being pushed more and more; banks are expected to keep that interest rate risk extremely low. And if you run out, then you have just violated an interest rate rule. You can do a certain amount of that and you have to stop. You just cannot take too big a hit.

So you go to your board and say, "I am going to allocate $2 million out of a $50 million portfolio and we will go 5 years on those loans because they need to be made." If I did not have some of these rules I might have allocated four.

Mr. LAUFFER. That is exactly right, and let me point out two other things with FASB and the Securities Exchange Commission. Not only do we have these statutes, but we have them coming in from the other side from mark-to-market accounting and so on. So Bill is exactly right. All of these things together. It just does not come from the regulation and you people; they come to us from our CPAs on one end, FASB on another end, the Securities Exchange on the other end.

Mark-to-market is a big concern for community banks. There is no question about it. I just got my annual report finished yesterday and I had a $1 million appreciation in my bond account. If I were to mark-to-market,—we footnote it and it is in there. If I had to mark-to-market, I could put $1 million more back in my profit, pay bonuses, pay dividends, pay everything. But it was paper profits. The same goes, if the market turns and I have a $500,000 depreciation next year, I have to come off my income if we go the whole way to mark to market.

These things Congress maybe does not have control over, but who does? Because they keep flying at us from everywhere, and these are not even elected officials. We really do not have a lot of ability to protest with these people. We just have got to go along with what they say.

Mr. BRANDON. And back on Jim's point, profit is not necessarily a bad thing because profit goes to the capital accounts; the capital accounts then multiply by eight or more back into the lending sector. So it is just all one huge puzzle that needs to fit together right, and we are just managing now to start to pull it apart, and the net effect is we have less credit out there.

The CHAIRMAN. Let me just close with an observation and a comment on one of your points, Mr. Lauffer.

Number one, Senator Nunn and I are going to re-introduce our monumental Paperwork Reduction bill next week. I do not know whether it will pass or not. It did not pass last year. It is one of those things people around here like to talk about, but when it gets down to really doing something about it in a meaningful way it is just very difficult to get it done. And everybody has their own ideas about paperwork reduction. But I can tell you it is killing the banks of this country. More than any other institution in America, the bankers are suffering most.

I do not have anything for or against bankers. I am just a small businessman. Incidentally, I was a struggling small businessman at one time and actually using my legal fees to sustain my business. And I decided to consolidate all of my debt with a small business loan. And I gave up because 30 years ago the paperwork burden was more than I wanted to go through. I was having to pay accountants and go through all those hoops on paperwork reduction and finally said, "I will struggle along the way I am before I am going to go through this." And I backed off.

But the other point I wanted to make was, you said you followed those CDs that left your bank, and they went into annuities and mutual funds. You know, I do not want to cause a stock market crash, but a 3,400 stock market today, in my opinion, is silly. You cannot justify it. You know why it is there? Because people like me would rather roll the dice on some stock like Walmart than to

leave it at 3 percent in a CD. Money is leaving banks by the billions and going into equity funds.

Mr. LAUFFER. Right. The problem here is unsophisticated investors. You have a lot of retired people who are now chasing yield who do not know the risk of being in a mutual fund or an annuity. And that is going to be the big problem. When that market makes an adjustment and they find out that their value was not the same as it was when they took it out of the CD—but it is out there, it is going to happen. It is a time bomb, in my opinion, waiting to happen.

The CHAIRMAN. You let the market drop 500 or 1000 points in one day, you will get all that money back.

Mr. LAUFFER. Lots of it has withdrawal penalties so that the people would not be able to get their money. And if you remember back in 1987, I guess, when the market dropped, some of them shut down their phones because there were too many people making withdrawals.

The CHAIRMAN. Yes. My son could not get through to his broker.

Mr. BRANDON. You have been very generous with us with the time. One more quick point.

I really like, Senator Bumpers, what you said, the correlation between the ethics and the huge manual and what is happening in banking. And I applaud you for trying to do the paperwork reduction. I would hope, though, that with the leadership of you two senators and others, that we could simply take a look at the banking regulation in the same light as the ethics regulation and say, "What are we really trying to accomplish?"

Take a hard look at it from the standpoint of what it would take, really, to get the job done and come back to Jim's point and say we are killing the consumer. Whether you like bankers or not, we are still that mainstream lender out there for the type business that you are talking about, and they are the ones that are getting killed by this thing. And I think if the Senate would say, "Let us back up and look at this thing again and say what are we trying to accomplish," and then look at the rules and the regulations from that standpoint. And I have confidence that if you do that, the banking industry is going to say, "Hey, we are with you."

Mr. LAUFFER. We have done this for many Congressmen, and just recently for a new Congressman from Pennsylvania—piled up our board table. And you are talking about this one manual. We can both fill your table from one end to the other with manuals that are thicker than that with everything in there that we have got to know to run a bank. It is darn near impossible.

Mr. BRANDON. It is impossible.

The CHAIRMAN. You know, there is not a country banker in Arkansas that cannot tell you within $1000 what every house in that town is worth, and yet he has got to go out and pay some appraiser to come in and tell him what he already knows and charge it to that customer.

Mr. BRANDON. That is right.

The CHAIRMAN. Finally, I know I speak for Senator Lieberman as well as myself. Bankruptcy reform is something I hope we do in a meaningful way this year. As a small businessman I took a couple of hits, big hits, from bankruptcies, and I tell you it is outrageous.

The bankruptcy laws of this country, my entire life, have been outrageous. So I pledge you my personal support to do everything I can to help on that.

Mr. BRANDON. We thank you for that.

Mr. LAUFFER. I appreciate that.

Senator LIEBERMAN. I join the Chairman in thanking you. I was supposed to thank you for two things. One, for your courage in being willing to link yourself in any way with Congress. And we appreciate that very much because we are probably down at the bottom in public estimate. But I think the comparison here in terms of the sense of regulations is very accurate.

The second is for the practicality of your testimony, and to say to you and to echo the Chairman that we are going to try to do everything we can to accept the challenge that your testimony puts before us, which is to focus on results. Again, we know there have been hearings on this subject held before the various banking committees of the Senate and the House. We are focused on the other end of the process, if you will, the recipients of the loans. We know that they are not getting as much as they need to get this economy moving and create new jobs.

So I hope that, under the Chairman's leadership, we can play an active advocacy role, because of our preoccupation with the small business community, in freeing you from some of these Washington-based regulations that inhibit you from being the local bankers that have traditionally kept the economy going.

I again want to echo what Senator Bumpers has said, and what you have said. It is a small story but it makes a big point. The average banker that I know in Connecticut is a decent person who works hard, wants to serve the community, wants to make a good living. God bless him for that. And, most of all, he does not want to ever compromise his integrity or reputation.

In addition, as Senator Bumpers has said, that banker knows a lot better than anybody promulgating a regulation here about appraisals or a whole host of other questions whether a person in New Haven, Connecticut is credit-worthy or not. We have somehow got to figure out a way to get back to that essential relationship. So thanks for helping us to do that.

The CHAIRMAN. Thank you both very much.

Senator LIEBERMAN. We go now to the final panel, and I thank the two final witnesses for their patience. Mr. William Rossman, president of the Robert Morris Associates and president and CEO of Mid-State Bank and Trust of Altoona, PA; and George Burnell, president and CEO of Icon Corporation, Woburn, MA.

We have a lot of icons around Washington, Mr. Burnell, so it is nice to welcome another one. Hope you will feel at home here.

Mr. Rossman, it is all yours.

STATEMENT OF WILLIAM J. ROSSMAN, PRESIDENT, ROBERT MORRIS ASSOCIATES AND PRESIDENT AND CEO OF MID-STATE BANK AND TRUST, ALTOONA, PA

Mr. ROSSMAN. Mr. Chairman, Senator, my name is William J. Rossman. I am president and CEO of Mid-State Bank and Trust Company, Altoona, PA. My bank is an affiliate of Keystone Finan-

cial, Incorporated. I was invited to testify today as the current president of Robert Morris Associates. It is a trade organization of lending and credit officers which has 2800 member banks and about 15,000 individuals.

We, as an association, rarely comment on legislative issues. We do not engage in lobbying, and we really do, as our job, try to help the lending process of all the banks throughout the country.

I would like to start with a quote if I may from someone you all know. "In business it is not how much money you have; it is how much you can borrow. That is what is important." Walt Disney said that 60 years ago. And I think it is very important and I think the other person testifying today will realize what we are talking about.

Last weekend, RMA held its board meeting and I was able to share Chairman Bumpers' letter with the other board members. At least this has given me a little broader perspective on some of the issues raised. I might add that while many of the largest banks in the country belong to RMA, the bulk of our membership is small community banks. Many of our programs help these institutions better serve the needs of the small business borrower.

We continue to hear debate about the causes, cures, and even the very existence of the credit crunch. This is to be expected since the term means different things to many different people. All of us have a unique perspective. For instance, if you are a qualified borrower and you were turned down for a loan, there definitely is a credit crunch. While credit availability today is not comparable to that of the late 1980s, there certainly are few among us—legislators, regulators or lenders—who would assert that the late 1980's represented a normal lending period.

Instead of debating whether or not there is a credit crunch by one standard or another, I would like to take a different and, I hope, a more rewarding approach to the question of credit availability for small business. Let us assume for purposes of discussion that credit for small business or, for that matter, for business loans in general is not as readily available as it was a few years ago. Would this come as a surprise to anyone? I think not. Consider some of the changes that have occurred from the viewpoint of the loan officers, the regulators and the borrowers.

On the loan officers' perspective, we have gone through a period here which is very difficult to address. I have heard comments about the fact that so few young lending officers over the late 1980s had the experience of working through a period of adverse economic conditions. The implication was, once they had, they would approach things quite differently. Now these officers have had this experience and, in many cases, they are probably somewhat more conservative.

A fair and equitable credit benefits both parties, the lender and the borrower. A poor credit benefits absolutely no one. Therefore, given the economic decline, even if nothing else has occurred, the tendency for loan officers and bank management is to be more conservative in their lending practices than they were before.

Regulators. It is not my intention to come before the Committee and criticize the action of the regulators, although there is at least anecdotal evidence of uneven treatment of bank lending both

among Federal agencies and within agencies. Nevertheless, it does appear that regulatory actions in recent years have contributed to the tightening up of bank lending standards. The end result is a more conservative, less flexible regulation and supervision, and this has had an impact on bank lending practices and policies.

I might emphasize one thing that was not discussed by the other people testifying today. Internally, each bank has lending policies and procedures, and because of the examinations we have had over the last number of years, they have been tightened. I think it will be quite a while before we see a relief from those restrictive credit policies. It has been done at the insistence—and somewhat to the benefit of many of the banks—but also at the insistence of the regulators over that period of time.

Let me address the borrowers. Declines in bank credit reflect both a demand and a supply factor. Many borrowers recognize that their financial statements are not strong enough to support any further credit extensions. Some borrowers have not paid back previous loans, and further borrowing at this point may be illogical if not impossible. The basic problem is not that the banks do not want to lend but, rather, the lack of creditworthiness of someone who borrows or comes to the bank for credit.

I might also add, in our discussions at the RMA board meeting it was said by a number of the banks that right now the way credit demand and loan demand is, they would do anything to go out and try to secure new business. In fact, when a new piece of business is located, they are finding that two, three, or maybe even four banks are already there trying to solicit the new business of a creditworthy borrower. And I think it is important to make that point.

Indicative of this, at our RMA board meeting, it was pointed out by bankers from different parts of the country that many borrowers are paying loans down, not expanding them. One banker observed that, at present, he has the lowest usage of commitments in the history of his bank. The supply of funds is there but is simply not being used.

Senator, you asked the question before about the spread between the cost of funds and bank lending rates. I might note that if we were strictly in the lending business based on spreads we could probably lay off 100 people at our bank-we have 600 employees at Mid-State Bank. But I look at the lending function being a way that we are going to survive for the future. We are not going to lay off our staff and be able to create jobs, not only within the bank but in our communities. We create jobs by meeting the lending demands in our community. I think that is very important and I think all banks try to do so.

On a more positive note, many of the bankers did feel—and Board Governor Mullins indicated this morning—that, for the first time, there is an indication that loan demand may be turning around, and hopefully we will be seeing some of that in the future.

In conclusion, I would like to say that new regulations and interpretations of existing laws have created uncertainty in lending which has added to the time required to process a loan and substantially increased its cost. Banks desperately need a stable environment, time to digest what has happened with FDICIA, and a host of other laws enacted in the past few years. I hope there will

also be some relaxation of existing laws because in the past decade little has been done to encourage lending by anyone.

My recommendation to you today would be to let us get back to our job of making sound loans. We have become overwhelmed with paperwork, we are constantly threatened with lawsuits, and the standards applied to us seem to be continuously changing. We need your help in creating the kind of environment in which we can focus on the fundamentals of commercial lending and return to the examination of the five Cs of credit on which our association, RMA, was founded and which are the basis for sound lending. They are: character, capacity, capital, collateral and conditions. All five taken together is how we extend good credits.

Thank you for inviting me to testify today, and I look forward to answering any questions.

[The prepared statement of Mr. Rossman follows:]

PREPARED STATEMENT OF WILLIAM J. ROSSMAN, PRESIDENT AND CEO, MID-STATE BANK AND TRUST COMPANY AND PRESIDENT, ROBERT MORRIS ASSOCIATES

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE U.S. SENATE COMMITTEE ON SMALL BUSINESS: My name is William J. Rossman. I am president and CEO of the Mid-State Bank and Trust Company, Altoona, PA, a $1 billion bank. My bank is an affiliate of Keystone Financial Corporation, a $53 billion multibank holding company.

I was invited to testify today as the current president of Robert Morris Associates (RMA)—a professional association for commercial lending and credit officers established in the early 1900s. At present, RMA has approximately 2,800 commercial bank and thrift institutional members which are represented in the association by nearly 15,000 individuals. RMA emphasizes education, training, peer sharing, and professionalism in the lending and credit area. The genesis of RMA was credit information exchange, and helping borrowers obtain appropriate credit is central to our day-to-day activity.

As a professional association, RMA rarely comments on legislative questions. Other associations, such as the American Bankers Association and Independent Bankers Association, have skilled professionals who concentrate much more on legislative concerns. As a matter of fact, RMA's legal counsel watches our activities very carefully to help us ensure that we do not engage in lobbying. I do not recall RMA appearing before a congressional Committee in more than a decade. I hope the rust does not show too much.

Today, I will address the specific questions raised in the Chairman's February 24, 1993, letter inviting me to appear as a witness. Needless to say, I have not had an enormous amount of time to prepare testimony, and RMA does not have established positions on legislative issues to which I might refer for guidance. Therefore, I would stress that my credentials are those of a lending and credit professional, not a legislative expert.

In speaking to you today, I will have to draw very heavily on my personal experience as a commercial lender and as a bank president in a small rural community. Fortunately, last weekend RMA held its winter board of directors meeting, and I was able to share the chairman's letter with the board members. At least this has given me a little broader perspective on some of the issues raised. I might add that while many of the largest banks in the country belong to RMA, the bulk of our membership is small, community banks. Many of our programs, training materials, and committee activities are aimed at helping these institutions better serve the needs of their small business customers.

THE CREDIT CRUNCH

We continue to hear debate about the causes, cures, and even the very existence of a credit crunch. This is to be expected since the term means different things to different people, and each of us seems to approach the issue from a unique perspective. For example, if you felt you were qualified for a loan and your application was turned down, it would be hard to convince you that there was no credit crunch. This has led some people to call for a more objective analysis of the credit crunch—an

analysis that is less influenced by the personal feelings of those involved directly in a specific transaction.

Some have suggested that it would be most logical to address the credit crunch question by asking whether current lending patterns conform to standard practices at the same phase of previous cycles. In theory, this sounds like a logical approach. But in real life, things do not stand still, and business cycles are neither uniform nor easy to measure. Therefore, while we can learn much from history, we must also recognize that the central theme in our economic environment in recent decades has been change and that comparisons of commercial lending from period to period are not very meaningful.

This is especially true in contrasting bank credit availability in the late 1980s with the current situation. While acknowledging the severe limitations of their statistics, Federal Reserve Bank of Richmond economists used the Federal Reserve Board's Senior Loan Officer Opinion Survey data to compare current lending conditions with those in earlier business cycles. Their conclusion was that from a historical perspective, recent credit responses appear to most closely resemble those of the 1969 and 1973-74 recessions.

While credit availability today is not comparable to that of the late 1980s, certainly there are few among us—legislators, regulators, or lenders—who would assert that the late 1980s represented a "normal" period in credit markets. We have all lived to regret the excesses of that period, and we certainly do not want to return to those conditions.

A DIFFERENT APPROACH

Instead of debating whether there is or is not a credit crunch by one standard or another, I would like to take a different, and I hope a more rewarding, approach to the question of credit availability for small business. Let us assume for the purpose of discussion that credit for small business, or for that matter for business loans in general, is not as readily available as it was a few years ago. Would this come as a surprise to anyone? I submit that in recent years the overzealous expansion of credit contributed significantly to the thrift crisis and the related difficulties in commercial real estate in general. Therefore, there has been a tightening of loan policies and a tightening of the internal loan review process, along with closer scrutiny of loans by the regulators. Consider some of the changes that have occurred from the viewpoints of loan officers, regulators, and borrowers.

Loan officers. At RMA meetings in the late 1980s, I often heard comments made about the fact that so few young loan officers had ever had the experience of working through a period of adverse economic conditions. The implication was that once they had done so, they would approach things differently. Now these officers have had this experience, and in many cases, they probably are somewhat more conservative. This is not necessarily bad from the perspective of the lender who wants to be repaid nor from the perspective of the borrower who wants nothing more than to be able to repay according to the terms laid out in the loan agreement. A fair and equitable credit benefits both parties, the lender and the borrower. A poor credit benefits no one. Therefore, given the economic decline—even if nothing else had occurred—the tendency for the loan officer and bank management to be more conservative in their lending practices could have been predicted.

Regulators. It is not my intention to come before this Committee and criticize the actions of the regulators, although there is at least anecdotal evidence of uneven treatment of bank lending both among the federal agencies and within agencies. But the banking agencies are large organizations, and communication is not always perfect. Also, communication is not always perfect between the regulator and the bank.

Nevertheless, it does appear that regulatory actions in recent years have contributed to the tightening up of bank lending standards. In part, this may be traced to the actions of examiners and their supervisors who have been criticized by Congress and the General Accounting Office, by various "watchdog groups," and by others who felt that the supervisory standards were not what they should have been. It may also be traced to a broad range of new regulations, particularly those arising out of the Federal Deposit Insurance Corporation Improvement Act of 1991.

In the great majority of cases, the examiners are simply doing their jobs to the best of their abilities, and the agencies are taking action required by law. But the end result is more conservative, less flexible regulation and supervision, and this has had an impact on bank lending policies and practices.

Borrowers. Declines in bank credit reflect both demand and supply factors. On the one side, many firms recognize the excesses of the 1980s, and they are trying to cut costs. As a part of this process, some firms are engaged in deleveraging, and their

demand for credit has been reduced. Large numbers of potential borrowers find that excess inventory is already available in their product lines, and with low inflation, or even disinflation, collateral values are down. In inflationary times, collateral value grows, but with disinflation, the reverse is true. Many borrowers recognize that their financial statements are not strong enough to support further credit extensions. Some borrowers have not paid back previous loans, and further borrowing, at this point, may be illogical if not impossible.

The basic problem is not that the banks do not want to lend but rather the lack of creditworthiness of so many of the borrowers who come to the bank for credit at the present time.

In some areas, major borrowers have been out of the market for years, and this is not just a phenomenon of the 1990s. Tax laws, for example, have taken their toll on borrowing since numerous projects undertaken before 1987 would be unprofitable today. One senior lender remarked to me recently that the commercial lending business was so slow in his bank that they did not even need a receptionist on the loan floor.And indicative of this, at the RMA board meeting, it was pointed out by bankers from different parts of the country that many borrowers were paying loans down, not expanding them. One banker observed that at present, he had the lowest usage of commitments in the history of his bank. The supply of funds is there, but it simply is not being used. On a more positive note, the bankers did feel that the signs are very good that loans will be increasing in the near future. In the words of one banker, "We are close to turning this around."

THE LENDING ENVIRONMENT TODAY

During the past decade, the lending environment has been affected by such developments as skyrocketing bankruptcy numbers and growing lending challenges from environmental risks. These factors, combined with the numerous other items previously noted, have significantly affected credit availability. Some banks that had serious loan problems in 1989 and 1990 put policies in place to try to ensure this would not happen again, and they did so with strong encouragement from their regulators.

The bank lender's mind set has changed. Having experienced massive losses, numerous bank and thrift failures, executive turnover, more regulatory criticism, and closer scrutiny of their decisions, it is natural for lenders to approach their jobs with more conservative attitudes. Nevertheless, bankers want to lend, but the obstacles to lending are tremendous. (A few illustrations of these obstacles are noted in Exhibits 1, 2, and 3 attached to this paper.)

To bring things closer to home, consider the items my bank would require in evaluating two small business financing requests which are similar to those we see most often in the market area we serve:

Borrower #1 is requesting financing to purchase an existing business and the related real estate.

The following is a list of items we would require to process this request:

(1) Three to five years of business financial statements and tax returns.
(2) Business plan.
(3) Projections of performance and budgets.
(4) Personal financial statements and tax returns.
(5) Certified appraisal on business property.
(6) Environmental Phase I Audit on business property.
(7) Independent appraisal or valuation of fixed business assets.
(8) Agings of accounts receivable, accounts payable, and inventory.
(9) Certified appraisal on any residential real estate.
(10) Listing and valuation of any other collateral to be pledged.
(11) Dun & Bradstreet report on business.
(12) Market and competition analysis.
(13) Personal credit check.
(14) Copy of sales agreement.
(15) Personal biographies and resumes of purchasers.
(16) Secured transaction checks at state and county levels (UCC searches).
(17) Attorneys for seller and buyer will provide:
 —Schedule of all assets.
 —Schedule of all creditors and liabilities.
 —Affidavits certifying compliance with bulk transfer request.
 —All matters pertaining to litigation.
(18) Articles of incorporation and bylaws or partnership agreement or fictitious name registration.

This is the information that we would need to receive and digest prior to internal bank analysis. Following the receipt of information, we will do our internal analysis to include the following:

(1) History and background of the company and its industry.
(2) Financial analysis.
(3) Compliance of the borrowing request with regulatory requirements and internal bank policies.

Borrower #2 is requesting financing to start a new business including the purchase of real estate.

All of the requirements of Borrower #1 would need to be followed. But we would need to do more research on the market and the competition due to the start-up nature. We also would be relying primarily on the pro forma financial statement and business plan for the credit analysis. Additional emphasis would be placed on the collateral analysis due to the lack of a track record. We would be much more stringent with all requirements for a start-up business as opposed to an existing business.

I would be happy to elaborate on the above in the question-and-answer part of the hearing, if the Committee desires.

A NOTE CONCERNING MY PERSONAL EXPERIENCE

Perhaps it would be helpful to the Committee if I would relate my own experience at Mid-State Bank and at the other banks within our holding company, Keystone Financial Incorporated. The new laws and additional regulations which we have encountered in recent years, in my opinion, have significantly slowed the credit process. We have had to dedicate a substantial amount of resources and a considerable amount of time to the interpretation of many of the new laws and regulations. We had to revamp our internal compliance process, upgrading our staff at considerable cost for training. We also had to increase our personnel commitment in this area. At Mid-State Bank we take the commitment to the communities we serve very seriously, and we make every effort not only to comply with but to exceed the requirements of the Community Reinvestment Act. In this regard, we are proud that we were awarded an outstanding rating by the regulatory examiners.

We found it necessary not only to educate our employees but to re-educate our customers because of the new requirements which must be met to comply with regulations. This was no easy matter. Many of the small businesses with which we deal are managed by only one or two key people and this placed a tremendous demand on their time. Therefore, if we were to continue to extend credit in our market, it became imperative that we provide guidelines to assist our customers whenever possible. (The above checklist of items relating to two different types of borrowers is an example of the sort of guidelines we provided.)

Under new regulations, we found it necessary to demand from our customers complete and verifiable written information that could be then put in the credit files. Verbal assurances of compliance were no longer acceptable either in our internal loan review process or in the external regulatory process. We, therefore, added an additional layer of paperwork onto the borrower to support either his loan request or credit extension. I would strongly suggest that not only small borrowers but small banks are having a very difficult time properly addressing so much change and so much added red tape. It is extremely burdensome to function in this environment.

At our bank and in our holding company, we find it necessary to separate the small business and agricultural functions from our usual corporate business. We formed new specialized small business units that we feel are able to better work with and extend credit to this particular market. We accelerated the education and training of our lending officers and provided them with marketing support and assistance in supporting the small business market.

We also better defined our credit policy as to what types of loans we were willing to consider and those which were outside of our policy. (I should quickly add that even loans outside our credit policy may be reviewed for consideration but reported to our loan committees and board as exceptions to the credit policy as written.)

Nevertheless, even with a well-crafted, somewhat conservative credit policy, we have still been able to maintain loan demand at Mid-State Bank at a relatively high level even during the recession. But this has come at considerable cost to the bank and to a significant degree this must ultimately show up as cost to the bank customer.

Concluding Note. New regulations and interpretations of existing laws have created uncertainty in commercial lending that has added to the time required to proc-

ess a loan and to its cost. Banks desperately need a stable environment for a few years—time to digest what has happened with FDICIA and a host of other laws enacted in the past few years. I hope there will also be some relaxation of existing laws, for it could be argued that in the past decade, little has been done to encourage lending. The bulk of the regulatory and legislative actions taken in this time span have made the process more difficult. While we will leave the legislative recommendations to our colleagues in the American Bankers Association and Independent Bankers Association, I would respectfully submit the following recommendations for consideration by the Committee:

(1) The implementation of Section 132 of FDICIA will, many predict, tighten credit. Section 132 calls for the regulators to adopt credit underwriting standards. We hope that both the Congress and the regulators will be understanding and regulations will evolve which are sufficiently flexible so that they do not interfere with the bank lending process.

(2) The appraisal process has created numerous problems for banks in the extension of credit, particularly to small business. It has added substantially to cost and to the time required in processing a loan. We would certainly like to see an increase in the stated minimum dollar figure in the appraisal rules.

(3) The paperwork burden that the banking industry faces has been pointed out time and again by various banking groups as well as the Federal Financial Institutions Examination Council. It should be sufficient for us to say that we strongly endorse any effort to reduce this burden. The ABA and IBAA representatives, I am sure, will be much more specific in regard to other needed legislative changes.

My recommendation to you today would be to let us get back to our job of making sound loans. We have become overwhelmed with paperwork, we are threatened with environmental suits, and the standards applied to us seem to be continuously changing. Robert Morris Associates is trying to help small business borrowers by developing a carefully designed package of materials to be submitted by the borrower. This should speed up the process considerably. But we need your help in creating the kind of environment in which we can focus on the fundamentals of commercial lending and return to the examination of the Five C's of Credit on which our association was founded and which are the basis for sound lending: character, capacity, capital, collateral, conditions.

Thank you for inviting me to appear before the Committee and I would be happy to respond to any questions which you may have.

Exhibit 1

Sample of Regulatory Costs Associated with Small Commercial Real Estate Loan Closing

Borrower: ABC Properties, Inc.

Loan Amount: $500,000

Collateral: First mortgage on improved commercial real estate (retail facility)

Regulation examples: FIRREA, ADA, Fair Housing Act, FDICIA, EPA regulations (i.e., wetlands)

Direct regulatory expenses associated with loan closing:

Legal counsel--borrower and lender	$19,500
Appraisal	4,000
Environmental assessment	3,750
Building inspector--lender (ADA)	3,000
Surveys	2,200
Title search and insurance	750
Total*	$33,200

*Equates to 6.64% of the loan amount

Indirect regulatory expenses associated with loan closing:

Personnel time to monitor and report compliance with regulations	**
Personnel time to create policies and educate employees to keep bank in compliance with laws and regulations	**
Personnel time to deal with and prepare for auditors	**
Personnel time to review project-specific compliance (e.g., ADA, FIRREA, EPA Regs) and educate customer on necessity of and changes in regulations	**

**Costs will vary by institution depending on the makeup of the loan portfolio

Exhibit 2

Summary of XYZ Company
Costs to Secure $192,000 Term Loan

Phase I Environmental Study	$ 3,200
Appraisal (for collateralized real estate)	1,100
Title insurance	1,150
Life insurance (keyperson)	300
Legal costs	3,500
Accounting	2,500
Service fee - (1%)	1,920
Bank recordation fees	350
Total	$14,020

Exhibit 3

Profile of Related Costs
in Securing a Small Business Loan of $200,000

	Category	Range of Costs
[a]1.	Real Estate Appraisal Fees	$ 200 to $ 2,500
2.	Environmental Assessment (Phase I)	1,000 to 3,500
3.	Title Insurance/Loan Closing Costs	750 to 2,000
[b]4.	Small Business Administration Guaranty Fee (for $200,000 loan)	3,400
[c]5.	Accounting & Loan Packaging Fees (for business plan)	500 to 2,500
6.	Documentation Filing Fees	475 to 600
7.	Keyperson Life Insurance (w/beneficiary assignment)	250 to 750
[d]8.	Legal Costs (borrower's)	500 to 3,000
		$7,075 to $18,250

---

[a]Depends on level of appraisal and appraiser certification required.

[b]SBA Guarantees are available to $750,000--fees are based on 2% of loan amount X Guarantee percentage (generally 80% to 90%).

[c]Depends on the detail of a business plan. Start-up businesses also require three years of pro forma financials and cash flow forecasts.

[d]Legal costs borne by borrowers often related to review of business purchase agreements, franchisor agreements, bank documents, etc.

The CHAIRMAN. Mr. Rossman, if I may, my paternal grandfather was a country businessman and it was not uncommon for people like that in rural areas to do most of the lending, more than banks did. And I remember as a child—I never understood it until later—he never took collateral. He always said, "There is more in the man than there is in the land."

Mr. ROSSMAN. And he is totally right.

The CHAIRMAN. I wish we could go back to that.

Mr. ROSSMAN. The character part, Senator, is very important. We realize that is a part that the regulator does not see, will never see. Only the banker that has contact with that customer sees the character of the borrower, and that is extremely important. That is the first of the five Cs.

Senator LIEBERMAN. Well said. I am sorry Senator Burns has left. He asked me earlier in the morning if I could fill in the two C's that he had forgotten, and you have given me that testimony.

Mr. Burnell, I want to say before we ask you to begin your testimony that Senator Kerry just sent me a note expressing his regret that because of an unavoidable conflict he cannot return to hear your testimony, but he thanks you very much for coming down from Massachusetts, and he knows that you speak for a whole host of business people up there. We welcome your testimony.

STATEMENT OF GEORGE BURNELL, PRESIDENT AND CEO, ICON CORPORATION, WOBURN, MA

Mr. BURNELL. Mr. Chairman, Senator, thank you for this opportunity to explore the financial needs of small business as we emerge from the recession. My name is George Burnell, and I am here as President of Icon Corporation of Woburn, MA, a company of 35 employees that has been producing industrial computers as well as machinery to automate electronic assembly, automotive and medical manufacturing for 25 years.

From 1977 to 1990, we were with the Bank of New England with a revolving line of credit of $800,000 supported by 80 percent receivables and 25 percent of inventory, plus a $300,000 term loan from Massachusetts Business Development Corporation supported by machinery and equipment, and a $200,000 term loan from Massachusetts Technology Development Corporation.

During 1981 to 1983, the company was buffeted by recession and by imports of machine tools. By the time I took over in 1983 the company had a $600,000 negative net worth. But the bank stayed with us. And from 1983 to 1990, we grew at 30 percent a year, earning our way to a positive net worth and generating 15 percent to 20 percent in export sales. Then the bank failed. The regulators got tough, and credit in New England vanished. Our credit line was reduced from $800,000 to $400,000. We were forced to sell off demonstration equipment, reduce our marketing efforts, and withdraw from the export market.

Surviving the recession of 1990 to 1992 was far more difficult than in 1981–1983 because of the collapse of bank credit. And we are far more fortunate than many of our friends who are no longer in business.

Where do we go now? It is as if Agent Orange had obliterated New England and now we have to figure out how to be productive in the acrid soil. Senators, it was not necessary and it is not necessary. The demand is there. Our orders are up sharply. We are hiring and need more help. We have ample opportunity for export sales.

But how can we achieve this? We cannot borrow on the bond market. Inventories are no longer considered collateral for loans. Smaller banks are being merged into mega-banks.

After 15 years with the Bank of New England, we were moved out because the successor, Fleet Bank, instituted a $2 million minimum in their asset-based lending. The few community banks that are lending have limits of $250,000 to $500,000. Our new bank restricts our line to $400,000. We already have receivables that justify a higher limit. Inventories would support another $200,000.

So where do we go for growth? How do we support new jobs to get out of the recession? And what of the companies that are still being throttled out of existence even as the turnaround has begun?

One. We need regulatory practices that put more value on commercial loans and the creation of jobs than on the margin between interest on deposits and government securities or the sale of mutual funds. We need commercial banks that are, in fact, commercial banks.

Two. We need to preserve the small and medium-sized banks. It may seem that mega-banks are more efficient or that they appear sounder, but they do not serve the market that is creating most of the jobs in our society.

Three. Banks need to be in a position to rely on all collateral available in a business including inventories. There needs to be relief from the recent emphasis on doubling up on collateral. Personal assets cannot possibly support business demands.

Four. SBA loans are not readily available, nor are they properly constructed for a growing economy. The fledgling program to support receivables and inventory needs to have a much longer horizon than the present one year and be constructed so that more banks can participate.

Five. Bank credit, SBA loans and quasi-public lending should provide components that support growth, such as a percent of assets, and not rely too heavily on term loans which shrink just at the time that demand is rising.

Six. Companies need regional bank credit at reasonable interest rates. Private lending at exorbitant rates destroys marginal businesses that might otherwise prosper and create jobs. In times of stress, Chrysler, IBM or General Motors are treated differently than small New England businesses have been treated.

Seven. We need quasi-public funding agencies devoted to the creation of jobs, growth and a healthy economy rather than focusing on financial ratios and the agency's financial returns. Business needs responsible sources of subordinated debt.

Eight. On November 9, 1992, the Massachusetts congressmen and senators outlined their recommendations to then President-Elect Clinton. They are thoughtful, responsible, comprehensive, and should be put into effect.

Nine. Do something. We began our SOS in 1990. The ship of state passed us by and many drowned. More will drown. It is time to pick up the survivors. A major opportunity to heal the economy is about to be lost. It is critical to act.

Small business is the foundation of the economy and the engine of growth. Give it fundamental credit opportunity and watch it lift the economy, generate jobs and relieve the national debt. Thank you.

Senator LIEBERMAN. Thank you, Mr. Burnell, for that excellent series of recommendations. I suppose we should begin by congratulating you for making it through the recession and the credit crunch to be here today.

Mr. BURNELL. It was tough.

Senator LIEBERMAN. I know it was. That is why I congratulate you.

I am curious—and I have just one question for each of you—about the amount of your time as a businessman that you spend in pursuit of the capital necessary to run your business, if you could just reflect on it. In other words, how much time did it take after BNE went under and you had to deal with Fleet—are you spending more or less time now that you are kind of out from under?

Mr. BURNELL. We settled with a new bank in September, and from that point on it has been a minimal amount of time.

From 1990 until we settled in September 1992, however, the amount of physical time devoted to it was maybe 25 percent of my time. The problem was the emotional stress of it really left me unable to constructively run the business.

Senator LIEBERMAN. And would you say that is a typical situation, from what you know, of people in business?

Mr. BURNELL. Yes. I would say not only is it a tremendous drain in time but it is a bigger drain in the sense that you are no longer able to constructively. You cannot focus on the future. You cannot do anything for tomorrow, you cannot plan ahead, you cannot take any risks. Basically, it is like trying to fight with both hands tied behind your back.

Senator LIEBERMAN. You cannot really operate your business.

Mr. BRANDON. You do not operate the business. Business operates in spite of you.

Senator LIEBERMAN. Right.

Mr. ROSSMAN. Senator, I will echo those remarks, too, because I get a chance to see a number of small business credits come before the bank in review. There are two attachments, exhibits, to my testimony, also. But what I see is most of the small businesses are run by one, two or three key executives, and we are putting them through hoops now that require weeks, sometimes months, to get through a loan request. It was never like that before.

I started in this business 30 years ago, and a lot of it was done based on a note signed without a lot of the other things that went with it. Perhaps there are some things that need to be done and have been done over the years, but I think it has gone too far.

We are placing all this burden not only on the banks but also on the small business borrower. That is our bread and butter—99 percent of my bank's loans are to small businesses. And if we lose them, we lose a big part of our community and ability to really

function going forward into the future. And I feel very sorry for the people who have to do that on a continuous basis.

RMA is in the process of trying to develop a package right now that we would be able to give to a small business borrower saying, "These are the things that you need to do and here are some ways to go about getting those things done." Maybe will reduce the cost, but I have doubts that it will accomplish this goal. It might save some time.

Senator LIEBERMAN. That leads to a question I wanted to ask you, and you said something very interesting during your testimony about the interest rate gap and the other factors that you consider beyond that.

But let us assume we were able to eliminate all the regulatory burden, the over-regulation, and still a lending officer or bank officer is faced with this series of options, which is: I can take money in a CD and give out a loan at 3 percent, or I can put it into a government security and get 6 percent with no risk. So, even forgetting the regulatory burden, why should I give it to a small business, even if I can get a little more interest because of the additional risk involved?

Mr. ROSSMAN. I guess the best way I can answer that is based on my personal experience in my community. Once we start looking only at spreads, we are going to see many more small businesses fail and they are the heart of our communities. It is because of them that we survive. If the long-term view does does not prevail, we are going to see a drastic reduction in small business across the country which will hurt everyone, including the economy and everything else that is involved.

Senator LIEBERMAN. It is a strong point and it is a simple point, but it is one that is missed, I think. I thank you for making it.

I thank the Chairman for his great support in holding this hearing. I think we have had excellent witnesses, and I hope, under his leadership, that this Committee will be able to play an active role in trying to improve this climate and make it easier for you to lend money, and you to do business.

Mr. BURNELL. I hope so.

Senator LIEBERMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Burnell, let me ask you one or two questions. You mentioned subordinated debt, the availability of going to the market with subordinated debt. What kind of subordinated debt?

Mr. BURNELL. In Massachusetts, we have the Massachusetts Technology Development Corporation. They happen to be the equity player in our business. They own 8 percent of the company, and even with the Commonwealth of Massachusetts owning part of our company I cannot get money.

They went in as a group with Mass. Business Development and the bank and they supported the company with $200,000 worth of subordinated debt, which puts the bank in a first position and, in essence, supplies capital that we were not able to supply as individuals. There are various ways of accomplishing that, but when I took over this business there were a number of community agencies that would go in jointly with banks to finance to support companies when those companies were supporting jobs in the society.

We generate $300,000 in tax revenues. You can afford to write off a couple of bucks, you know, to get that return on your investment. And nobody has lost any money on us. Ever.

So I think those are the sorts of programs that need to be looked at along with the recommendation I made that you use the full collateral of a company. I bought a boat at age 60 for 100 percent with 25 years to pay it off. Now, I would be 85 years old; that is crazy. I just bought a car this week with 100 percent financing. But the company can only get 50 percent financing, and the company generates jobs, supports tax revenue and supports 35 families.

The CHAIRMAN. That really is crazy, is it not?

Mr. BURNELL. Does not make any sense. Not from where I am sitting.

The CHAIRMAN. How big is Woburn?

Mr. BURNELL. It is a population of around 15,000 to 20,000.

The CHAIRMAN. Have you ever considered the availability of industrial revenue bonds? Have you ever approached the city about that possibility?

Mr. BURNELL. Industrial revenue bonds, at least in our area, are pretty much restricted to real estate. We do not have any real estate; we lease our building.

The CHAIRMAN. You lease your property?

Mr. BURNELL. Lease our property. So property is not part of our assets.

The CHAIRMAN. Do you own the business?

Mr. BURNELL. I own 45 percent of it.

The CHAIRMAN. Who owns the remainder?

Mr. BURNELL. I have a partner who is basically a financial partner and it is his personal assets that have allowed us to go forward, who owns 45 percent. And then a minority stockholder owns 2 percent, and the State owns 8 percent.

The CHAIRMAN. Are you familiar with my capital gains bill?

Mr. BURNELL. No, sir.

The CHAIRMAN. It would allow a small business—well, it has two provisions. A $5 million business paid in capital or $100 million, and you hold on to the stock for 5 years and you get a 50 percent deduction on the gain. If that bill were to pass, would that be of any value to you? Would you be willing to issue stock in your company to either your financial partner or to anybody else?

Mr. BURNELL. That is a very difficult question to answer. Let me put it to you this way. There is no problem in issuing stock in the company if the terms are reasonable. The difficulty that most owners have is the issue of control.

The CHAIRMAN. Yes. You would dilute your ownership, of course, if your financial partner took a bigger equity position.

Mr. BURNELL. That is often not the problem. The problem is who then does assume control, and what is the specter of that position. And the other is, what are the terms. I have negotiated to sell a portion of our company for 10 years and I can tell you, the terms were always wrong.

The CHAIRMAN. Yes. Let me ask you three quick questions. Do you have health insurance on your employees?

Mr. BURNELL. Yes, sir.

The CHAIRMAN. What does that cost you a year?

Mr. BURNELL. We pay 100 percent of the insurance for our employees but we do not contribute to the family portion, and the cost of that is about, I think, $2000 a year per employee.

The CHAIRMAN. $2000 per employee.

Mr. BURNELL. It is in that range. Per employee.

The CHAIRMAN. Have you been sued under the Civil Rights Act at any time?

Mr. BURNELL. No, sir.

The CHAIRMAN. Do you have minorities employed there?

Mr. BURNELL. Yes, sir.

The CHAIRMAN. Do you have a good strong personnel policy where you try to make sure you do not get sued? You know, I voted for the Civil Rights Act but I think it is a problem for small business.

Mr. BURNELL. The problem of keeping current and behaving with all the restrictions for small business is extremely difficult. We have perhaps two advantages. One, the company was originally part of a major corporation and it was a divestiture, so some of that personnel policy stayed with us.

And secondly, I have been with three Fortune 500 corporations in my career so I have some pretty extensive experience. And I have got to tell you, frankly, we primarily live off what I learned in my prior experiences. And I think that is the difficulty with small business, because those without that experience just cannot cope with everything going on. There is too much for one person to have to know.

The CHAIRMAN. Mr. Rossman, do you want to comment on any of that?

Mr. ROSSMAN. Just that I would say that if you gave the bureaucracy additional people they could find fault with any personnel policy, I do not care where it is at. It is almost impossible to deal with all of requirements, and we are a much larger organization and spend a lot of time on it.

The CHAIRMAN. There is no way to fully protect yourself, is there?

Mr. ROSSMAN. I would like to see the perfect company. I think it is impossible to find a perfect company that complies with all.

The CHAIRMAN. I agree with you totally.

Mr. Burnell, you said something, and correct me if I am wrong. You said an SBA loan is not practical for you?

Mr. BURNELL. I have done a lot of looking for loans, and

I certainly do not know near as much about what is going on as you folks do, but I can tell you that SBA loans in our area are restricted to a few banks. If you talk SBA they send you to one bank specifically, and if you go to that bank and they are not interested then you stop looking for an SBA loan because that is the procedure.

I have talked SBA loans to several other banks, some large, some medium-sized, and they frankly do not have a lot of interest in it. One bank talked to us briefly because they have no SBA loans and because they are being pushed by people to have SBA loans, so they might do one just sort of on the token house account.

The CHAIRMAN. Gentlemen, let me say, since I am the sole remaining person here but Chairman of this Committee, in the 6

years going on 7 years that I have chaired this Committee, this has the best, most informative hearing I think we have had. Everybody has been extremely articulate on your personal problems. It is extremely important to us to know what the rank and file out there are going through. As I say, as a former small businessman, I am extremely sympathetic. I know how tough it was for me to get capital when I—I did not have anything but an honest face. That is about all I had to offer, not much collateral, not much of anything.

Yet, a current study that has just been revealed shows that, in the 1988–1989 years, small business created about 4.5 million new jobs in this country, and that was people with 20 or fewer employees. People with 20 to 500 employees lost about 500,000 jobs. And companies with over 500 employees lost—I have forgotten what it was. Much more than that.

So, you see, you throw those figures out to show that it is small businesses that is keeping this ship afloat right now, but nobody really believes that. They keep thinking—you know, when I was Governor I used to tell the chambers of commerce in small towns, you know, "General Motors is not coming to your community. IBM is not coming here. What you might do is get 10 companies that employ 50 to 100 employees, so do not overlook these little homegrown industries."

I know, as President of the Chamber of Commerce and the Industrial Development Committee and all that sort of thing, we used to go to New York and Chicago and try to attract everybody into this little town, you know. It was an absurdity on its face. And all around us, these small people were employing 10, 15 people and they were growing to 50 and some of them to 100. We ignored them.

But, in any event, we were trying to get somebody big there, but those jobs were all being created by small business. Now, today, my little home town has about five to eight plants that employ 50 to 100 people, and that is the best of all worlds, because if you have one employing 500 and it shuts down, the town is dead. So that is another factor involved in it.

But that is what makes my work on this committee interesting and challenging. I just keep plugging away and trying to figure out some way to make small business more attractive to bankers and figure out whether it is the regulatory burden, capital requirements, whatever it is. Let up so that those small businesses that really do have a future have a chance.

Well, I will not prolong this any longer. You have been very patient sitting through this and I thank you both very much, and I wish you both the best of luck.

We will stand in recess subject to the call of the Chair.

[Whereupon, at 1:00 p.m., the Committee was recessed, subject to the call of the Chair.]

O

ISBN 0-16-041577-2
90000
9 780160 415777